CURRENT ECONOMIC PROBLEMS

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PREFACE

Current Economic Problems, as the title suggests, is an exposition of urgent economic problems that today confront the people of the world, and more particularly of the United States. It does not contain elaborately detailed statements of the development of these problems, nor are its pages crammed with statistics. While *history* and *facts* have a place in the study of economic problems, we believe they may easily be over-emphasized. Material of this kind has been introduced into the present volume only when it has seemed likely to aid in the *interpretation* of the problem under discussion. We feel that the important thing, in the case of each problem, is for the reader to know *what the problem is* and *what can be done about it*. The emphasis, then, is upon *analysis* and *evaluation*, rather than upon history and facts.

The book is distinctly a joint product. The task of actual writing was divided about evenly between us, and the senior author served as general editor. Our almost daily association over a period of ten years has given us abundant opportunity to iron out difficulties in terminology and reconcile differences of opinion, and has resulted, we believe, in bringing to *Current Economic Problems* a higher degree of *unity* than is ordinarily found in collaborations.

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If it were not for the hope that a scientific study of men's social actions may lead, not necessarily directly or immediately, but at some time and in some way, to practical results in social improvement, not a few students of these actions would regard the time devoted to their study as time misspent. That is true of all social sciences, but especially true of Economics. For Economics "is a study of mankind in the ordinary business of life"; and it is not in the ordinary business of life that mankind is most interesting or inspiring. One who desired knowledge of man apart from the fruits of knowledge would seek it in the history of religious enthusiasm, of martyrdom, or of love; he would not seek it in the market-place. When we elect to watch the play of human motives that are ordinary—that are sometimes mean and dismal and ignoble—our impulse is not the philosopher's impulse, knowledge for the sake of knowledge, but rather the physiologist's, knowledge for the healing that knowledge may help to bring. Wonder, Carlyle declared, is the beginning of philosophy. It is not wonder, but rather the social enthusiasm which revolts from the sordidness of mean streets and the joylessness of withered lives, that is the beginning of economic science. Here, if in no other field, Comte's great phrase hold good: "It is for the heart to suggest our problems; it is for the intellect to solve them. . . . The only position for which the intellect is primarily adapted is to be the servant of the social sympathies."

—Arthur C. Pigou, *The Economics of Welfare*

CURRENT ECONOMIC PROBLEMS

1 THE STUDY OF ECONOMIC PROBLEMS

THE RISE OF THE FACTORY SYSTEM, WHICH INTRODUCED THE USE OF LARGE QUANTITIES OF CAPITAL AND THE APPLICATION of mechanical power to industrial processes, dates from the last quarter of the eighteenth century. "Other times, other customs," runs the proverb; and there can be no question that the "other times" in which we live today have brought with them decidedly "other customs," so far as economic life is concerned. Among other things, we have moved from a simple economic system into one that is most complex. The hand process has become the machine process, specialization by trade has given way in many instances to specialization by task, and the independent artisan who was once his own master is now a factory worker who is directed by a foreman, who takes orders from a superintendent, who is responsible to a general manager, who, in turn, is under the control of the board of directors and ultimately of a group of stockholders.

In economic life, as in other forms of human activity, changes that are made in the name of progress are often opposed by those who see in the proposed changes a threat to their individual self-interest or to social welfare. The introduction of the power loom was effected only by beating down the objections, and in some cases the persons, of the hand weavers. The movement for free public schools had to overcome the opposition of owners of private schools who feared competition, and of taxpayers who disliked the increased levies necessitated by this social project. Anti-trust legislation has been championed by those who regard great combinations as a menace to the public good, and condemned by the champions of *laissez faire* and those who stand to benefit through monopoly control.

Changes in the economic world almost inevitably bring gains to some persons and losses to others, and, consequently, economic changes give rise to what we call "economic problems." Since changes are continually occurring in a growing economic society,

we are faced, year by year, with economic problems old and new —the old ones returning from temporary retirement to plague us, and the new arising out of fresh combinations of circumstances and challenging us to solve them if we can.

The Nature of Economic Problems.—The existence of an economic problem means the existence of conditions in which the interests of some persons are being affected adversely. Since, in the study of economics, we look at matters from the social point of view, we may define an economic problem as a maladjustment in economic conditions which results in loss to a considerable number of members of society. No one who is informed on events of the day will question that such maladjustments do exist, and that they often lead to serious consequences. Violent fluctuations in the general level of prices, involuntary idleness on the part of some millions of workers, the failure of banks to which thousands of persons have intrusted their life savings, the inexcusably wasteful exploitation of our coal and petroleum resources—these are a few of the major maladjustments of twentieth-century economic life that still await solution. They are taken from the long list of economic problems that confront us, and that bring to some members of society a sense of economic injustice and insecurity as well as standards of living lower than need be if only we disposed effectively of these maladjustments.

We have referred to the fact that, as students of economics, we examine conditions from the social rather than the individual point of view. We are interested in studying our economic institutions and business practices with the primary purpose of determining their effects upon society, and not upon isolated individuals only. Because economists adopt the social outlook, the study of economics is rightly classified as a "social science." Indeed, we shall find that many of the problems that we examine are not economic problems pure and simple, but are related, in greater or lesser degree, to other social sciences as well. The problem of population, for example, is an economic problem, by reason of the relationship between population and wages; but it is also a problem in sociology, because of the relationship of population to the family, which is a social institution; and, finally, it is a political problem as well, through its connection with immigration. Few persons would dispute the statement that the tariff problem is both economic and political, or that the problem of poverty may be said to fall within

the province of economics, sociology, and political science, and not within the scope of only one of these fields.

Interrelationships of Social Problems.—Since many of the problems of today are related to several fields of social science, it is sometimes possible to find a remedy for one phase of a given problem while other phases go unsolved. The Negro problem, for example, was solved in part by the freeing of the American slaves. But the abolition of the institution of slavery in this country did not solve the Negro problem in its entirety. Its economic phase was not remedied by this step. Indeed, freedom increased rather than decreased the economic difficulties of the Negro; and so serious is the present economic maladjustment of the American Negro that large numbers of our colored population are living under conditions which cannot, with any degree of reasonableness, be considered an "American standard of living." The emancipation of the slaves introduced, moreover, a brand new political phase of the Negro problem; for with freedom came the question of the political status of this large group of citizens, which now comprises about one-tenth of our total population. This, then, is another phase of the Negro problem that remains unsolved.

Yet another illustration of the complications of social problems is to be found in the question of prohibition. Whatever one may think of the wisdom or unwisdom of attempting to discourage the use of alcoholic beverages through legislative measures, one cannot fail to see that the passage of the 18th Amendment and the Volstead Act, some years ago, gave rise to new social problems. The sudden closing of breweries and distilleries rendered practically worthless millions of dollars' worth of highly specialized capital, threw out of employment thousands of workers whose industrial lives had been spent in the liquor business, and destroyed the market for an appreciable part of certain grain crops. The political aspects of the problem of prohibition are evident to everyone who followed the presidential campaign of 1928, and the local elections of later years. Other serious problems that arose, in part at least, from our attempts to solve the liquor problem by legislation, were the loss of health and even life resulting from drinking poisonous "bootleg" liquors, and the growing strength (in both numbers and influence) of the metropolitan gangs that prospered from the illicit manufacture and sale of alcoholic beverages. We are not here considering the merits or demerits of either Negro slavery or prohibition, but merely indicating that out of an attempt

to remedy a specific social problem, maladjustments of other kinds often arise.

The Importance of Studying Economic Problems

It seems most unlikely that anyone who has kept track of current events during the past three or four decades could doubt that economic considerations have been playing a leading rôle in local, national, and world affairs, or that they are destined to occupy center stage for many years to come. Are there wars and rumors of war? Then they are more likely than not to have an economic basis, and are certain in most instances to have far-reaching economic consequences. And if, happily, the paths that we follow are the paths of peace, even then we do not escape the necessity of dealing with economic problems, for business depression, gross economic inequality, financial inflation and deflation, and many other types of economic maladjustment thrust themselves upon us from time to time. In these days of economic interdependence, he is indeed a *rara avis* whose lot is not affected by economic changes. We should be able, then, to assume an interest in economic problems, on the part of all members of society. It will be worth our while, however, to indicate briefly several specific reasons for undertaking the study of this subject.

Economic Problems and the Business Man.—The interest of the business man in economic problems is very often based upon self-interest. When changes threaten, which would interfere with the enterpriser in securing the land, labor, or capital needed in his business, with converting raw materials into finished products, with marketing his goods, or with retaining for himself whatever income he is able to make his business yield him, the business man is faced with the problem of combating these changes or adjusting himself to them once they have come upon him. That such changes do come from time to time will be clear to all who read the daily newspapers. We need not go far back in history to find instances of governmental restrictions being placed upon the supply of certain kinds of capital, such as nitrates and raw rubber; of manufacturers being required by law to pay compensation to injured workers; of "interference" in marketing, with Better Business Bureaus and similar organizations insisting that goods must measure up to the claims made for them; and of large percentages of profits and managerial wages being taken by the government, through excess profits taxes and income taxes. There

can be no question that business men need to know the "ins and outs" of economic problems that relate to their particular enterprises.

It was a problem of this kind that confronted the United States Steel Corporation in 1921, when the United States first enacted legislation definitely restricting the volume of immigration to this country. The late Judge Gary, who was then president of the Steel Corporation, announced publicly and in no uncertain terms that the erection of immigration barriers would interfere greatly with the operations of his company, by excluding from admission to the United States large numbers of southern and southeastern Europeans, upon whom the steel companies of America depended for their supply of unskilled labor. According to Mr. Gary, a reduction in the number of laborers available for employment in the steel works of the country would inevitably result in higher wages, and, as a consequence, in higher prices for steel. A further possibility, though it was not mentioned by Mr. Gary, was that of taking smaller profits in the event that conditions of demand for steel should not make it feasible to increase the selling price of this product. In any case, there can be no doubt that Mr. Gary was genuinely interested in the problem of immigration.

Similarly, a prominent manufacturer of woolen goods was much interested in an economic problem during the presidential campaign of 1928, and, indeed, was fearful that, through the election of a Democratic President and Democratic House and Senate, he would suffer serious economic loss. He contended that the success of his business hinged upon the continuance of a high tariff on manufactured woolen goods, and that the Democrats, if they got into power, might indulge in so violent a downward revision of tariff rates that he would be unable to manufacture his product in competition with the foreign makers of similar goods. As matters developed, his fears proved to be without foundation; for the Democratic presidential candidate, before the close of the campaign, not only promised publicly not to tinker with the tariff in the event of his election, but also secured similar pledges from the Democratic members of Congress. The fact remains, however, that this manufacturer is but one of the thousands of enterprisers whose attention has been directed to specific economic problems because these problems have threatened the successful operation of their respective businesses.

Of a different sort was the interest manifested recently by a

Philadelphia merchant in the problem of low wages. Though not much given to reading about social conditions, he one day learned from a magazine article that the minimum income on which a family of average size could live comfortably in Philadelphia was $2000. Upon consulting his payroll, he found that some of his own employees, who were the sole breadwinners of families even larger than the hypothetical family of 4.3 persons, were drawing annual wages as low as $1300. Genuinely concerned over the discrepancy between the wages he was paying and the minimum estimates of budgeteers, he sought out specialists in the field of industrial economics in the hope of discovering a remedy for what he considered a very undesirable situation. Unfortunately, there appeared to be no satisfactory solution of this particular problem in an economic order based upon competition. The incident shows, nevertheless, that an understanding of economic problems is of significance to socially minded business men—business men whose interest in economic processes is not limited to the possibility of extracting large profits from the operation of their enterprises.

Economic Problems and Intelligent Citizenship.—But the need for a working knowledge of economic problems is by no means confined to the business man. In these days of large-scale collective action, the average citizen is called upon, time and again, to vote, directly or indirectly, on matters of the greatest economic significance.

Ever since the World War, the country has faced the necessity of unraveling the knotty problem of Europe's indebtedness to the United States. The close of the war left us holding the promissory notes of Great Britain, France, Italy, and others of our Allies to whom we had extended credit in time of need. The original indebtedness has been scaled down materially, largely through reductions that have been made in the interest rates that the indebted nations are asked to pay. Shall we cancel these obligations, as many persons think advisable, or shall we attempt to collect them either in whole or in part? This is obviously a problem that concerns the country as a whole and its citizens as individuals, since the failure of Europe to pay these debts means the payment eventually by the people of the United States.

Another problem affecting large numbers of people is that of United States Treasury deficits, such as the two-and-three-quarter-billion-dollar deficit of the federal government in the year 1937.

Shall shortages of this kind be met by the imposition of excess profits taxes and by sharp increases in the rates of taxation on large incomes, or would it be wiser to raise the necessary revenues at least partly by the use of a general sales tax? Here, again, the decision is of vital importance, since the imposition of a sales tax would mean a levy upon those of very meager incomes, whereas the excess profits tax and high income tax would place the burden chiefly upon the wealthy.

If it should be said that these are exceptional cases, the point may be granted cheerfully, but with the comment that we are being called upon continually to elect men to represent us in deciding important economic matters, and that we have some responsibility in seeing to it that we are properly represented. We have the privilege of advising our lawmakers from time to time, and of repudiating them when they come up for reelection if they have failed to do our bidding. But this privilege, if it is to be exercised, carries with it the obligation to offer sound advice or none at all, and the ability to advise intelligently rests upon an understanding of the issues under consideration. Shall we change the tariff, and if so, shall we have an upward or downward revision? Shall we nationalize the railroads, as many nations have done, or leave them in the hands of private enterprisers? Shall we establish national employment exchanges and a federal system of unemployment insurance, or shall we, as in the past, depend chiefly upon private charity and local agencies to relieve the want and privation that invariably accompany business depression? Shall we continue to tolerate wild fluctuations in general prices, or undertake to eliminate or reduce price changes through governmental control? These are samples of scores of economic problems of the present day that demand attention. We cannot afford to intrust their solution to lobbyists and professional politicians. Maladjustments that affect the public welfare, as most economic problems do, are worthy of the close study of every person who takes his citizenship seriously.

Economic Problems and General Culture.—But even to those who do not enthuse over the exercise of the franchise in the interests of economic reform, the study of economic problems may have some appeal as a matter of general culture. If culture is, as Webster says, "the training, disciplining, or refining of the moral and intellectual nature," it would seem that an understanding of the causes of economic maladjustments and their effects

upon the welfare of society might well be considered a desirable part of one's cultural equipment. No one who has attempted seriously to analyze any of the major problems of economics today, will question that such analysis does contribute to the training and disciplining of one's intellectual faculties; and it can scarcely be denied that a sincere attempt to set right the maladjustments that so mightily influence human welfare may do something to develop and "refine" one's moral nature.

Indeed, economic discourse has become so much a part of our everyday life that a man takes something of a chance if he leaves home without being prepared to hold his own in economic argument. Not only in the college classroom, but in the restaurant, on the train, or at the club, one is expected to know why France devalued her monetary unit—the franc—and to have ready a solution of the American farm problem! We do not suggest that a study of general economic problems will enable one to attain a perfect grade in these encounters, but it should certainly help to improve one's score. The professional economist himself will sometimes admit that he does not have a sure remedy for every economic ill! But it is possible, in most instances, to get an insight into the nature of a given economic problem and to learn something of the circumstances that have brought about the maladjustment; and it is often feasible to choose from among the proposed solutions of the problem the particular one which seems most likely to relieve the situation, and to know why it appears to be superior to the others.

It would be unreasonable, of course, to expect all of us to be as well versed in problems of an economic nature as the specialists. There is no need, however, for anyone to make the mistake of the business man who concluded that all organized workers were grafters because he had learned of crookedness in a particular union in his city, or to accept uncritically, as many persons have accepted, the editorial dictum that the Russian experiment must inevitably fail because it is not in accord with the economic procedure that has made America great. Not only does the study of economic problems provide one with a fund of interesting, important, current information, but it impresses upon one the complexity of certain problems which on the surface may appear simple, and enables one to sift the wheat from the vast amount of economic chaff that nowadays finds its way into our newspapers and magazines. A little learning is proverbially a danger-

ous thing, but a moderate amount of time given to the critical analysis of economic problems will help to put one on guard against the acceptance of the "snap judgments" that are offered so freely in conversation and print.

The Feasibility of Altering Economic Conditions

In the opening paragraph of an article in which he discussed the possibilities of world peace, Albert Einstein, the noted scientist, once wrote: "Let me begin by stating this political conviction: that the State exists for man, and not man for the State. The same may be said of economic institutions. This is an old principle, laid down by those who rated human personality as the highest of human values. I should hesitate to restate it if it were not constantly in danger of being forgotten, especially in this era of organization and standardization."[1] Choosing from this quotation the part that relates to our present inquiry, we endorse most heartily Professor Einstein's suggestion that economic institutions exist for man, and not man for economic institutions. Economic institutions, like other social institutions, have grown up because they have seemed to serve a useful purpose, and when they have outlived their usefulness they can be, and should be, either modified or eliminated.

Man's Control of Economic Conditions.—And yet, there are a good many persons who appear to believe that economic forces are wholly beyond the control of man, and that economic institutions are sacred and must not be tampered with. When workers go on strike, either to force a wage increase or to prevent a wage cut, we are quite likely to find editorial writers advancing the theory that wages are determined by conditions of supply and demand, that neither employers nor employees can do anything about it, and that it is consequently foolish of the workers to call a strike in an attempt to control wages. Now we may accept the statement that the conditions of supply and demand determine wages, and even agree that this will always be the case in a competitive society, without conceding that particular social groups are "in the fell clutch of circumstance" and must resign themselves to whatever wages—high or low—the gods may send. The truth of the matter is that wages will rise whenever the demand for labor is increased without increasing the supply, or the supply of labor decreased without decreasing the demand. In Chapter 5,

[1] *New York Times Magazine*, November 22, 1931, section 5, p. 1.

we shall note in some detail a proposal for raising the wages of those in the low-income groups, by controlling the size of the population and hence the supply of labor. As for economic institutions, there is every reason to believe that they can and will be changed, whenever society deems a change desirable and takes the trouble to bring it about. A comparison of economic conditions today with those of a century ago, reveals the fact that the institution of free enterprise, for example, which is thought by many to be a prime essential of our economic society, has undergone extensive modifications in this relatively short period.

Some Attitudes Toward Economic Change.—It is true, however, that there are many obstacles that must be overcome before any important economic change can be effected. One of the most persistent is the attitude adopted by a surprisingly large number of persons, to the effect that there is no hope of bringing about reforms that involve changes in human nature. This was obviously the view of the member of the Daughters of the American Revolution, who is quoted as saying: "Can any woman pray for peace more than I? . . . But what can we do if it is ordained otherwise? Human nature can never change. Wars can never be eliminated. We must sacrifice and be ennobled. We must give and be rewarded in the hereafter."[2] Obviously, if society in general were to agree with this apostle of despair, there would be an end to all attempts to improve world conditions. Fortunately for social progress, there are many who are convinced that we are not so helpless as we are here pictured. So far as the bogey of "human nature" is concerned, it really matters but little, after all, whether human nature does or does not change, so long as its outward manifestations are brought into conformity with socially desirable ends. It may be questioned that human nature has changed sufficiently, in many millenniums, to affect greatly man's desire to acquire commodities and services; but there can be little doubt that the manifestations of the acquisitive instinct are less likely today than in the Stone Age to take the form of physical violence. To most persons this change would seem to be a gain; and the change, it may be noted, is one that is closely related to the development of the economic institution of private property.

A second notion that has done much to interfere with economic advancement is the curious idea that any sudden or far-reaching

[2] *New Republic*, June 6, 1928, p. 65.

change is, for some reason or other, immoral or irreligious. The attitude is illustrated by a pronouncement of the school board of Lancaster, Ohio, in 1828, which read as follows: "Sir: You are welcome to use the school house to debate all proper questions in, but such things as railroads and telegraphs are impossibilities and rank infidelity. There is nothing in the Word of God about them. If God had designed that his intelligent creatures should travel at the frightful speed of fifteen miles an hour by steam He would clearly have foretold it in his holy prophets. It is a device of Satan to lead immortal souls down to Hell."[3] Read a hundred years after it was penned, this letter sounds more than slightly ridiculous, but probably not more ridiculous than certain present-day economic views will sound when examined in the light of the twenty-first century. We may feel pretty certain that the wise men of a hundred years hence will get many a chuckle from reading about twentieth-century opposition to family limitation, practiced in the interests of high standards of living; opposition to the control of credit, designed to stabilize the general level of prices; and opposition to the control of natural resources, advocated to preserve a supply of raw materials for the use of future generations. We have not as yet, we may frankly admit, got over the notion that there is something immoral about interference with economic *laissez faire.*

Yet another attitude that blocks economic progress is illustrated by the story of a tramp, as related by Lady Asquith in her autobiography.[4] Her account is as follows:

Another day, when it came on to rain, I saw a tramp crouching under the dyke, holding an umbrella over his head and eating his lunch. I went and sat down beside him and we fell into desultory conversation. He had a grand, wild face, and I felt some curiosity about him; but he was taciturn and all he told me was that he was walking to the Gordon Arms, on his way to St. Mary's Loch. I asked him every sort of question—as to where he had come from, where he was going, and what he wanted to do—but he refused to gratify my curiosity, so I gave him one of my cigarettes and a light and we sat peacefully smoking together in silence. When the rain cleared, I turned to him and said: "You seem to walk all day and get

[3] D. M. Keezer, and others, *Problem Economics,* New York, Harper & Brothers, 1928, p. 59.

[4] Emma Alice Margaret Asquith, *Margot Asquith: An Autobiography,* New York, Doubleday, Doran & Company, Inc., 1920, vol. 1, p. 40.

nowhere; when you wake up in the morning, how do you shape your course?"

To which he answered: "I always turn my back to the wind."

In things economic, as in so many other matters, a large number of the members of society appear to be content to turn their backs to the wind or to drift with the stream—in other words, to allow the force of inertia to prevent their doing anything about the economic conditions which they professedly regard as deplorable, but in which they are not sufficiently interested to enter actively into a search for a remedy and a fight to bring about its adoption.

The Plaint of the Tired Reformer.—Closely akin to the attitudes that we have described—at least in its effects in retarding economic change—is that of the tired reformer. Mr. Bruce Barton is a specimen of this type, if we may accept his own statement as it appeared in a popular magazine.[5] "The three reasons why I personally have retired from the reforming business," said Mr. Barton, "are: First, because I am getting older. Second, because I think that if every man takes care of his own life and his own family the total result is going to be pretty satisfactory. . . . Third, the forces that are working to make the world better are so powerful and are making such satisfactory progress that they do not need any great amount of artificial stimulation."

The relationship between Mr. Barton and Lady Asquith's tramp should be apparent. Both are fairly well satisfied with conditions as they are, or at any rate both have decided to turn their backs to the wind. There seems to be, in a case of this kind, more excuse for the tramp than for the tired reformer. Certainly the latter cannot plead ignorance of the situation as a defense of his inactivity; and his suggestion that "satisfactory progress" is being made can scarcely be credited unless the cause he formerly championed is getting along quite as well without his help as with it. However this may be, the defection of those who have been associated with economic reform, and their lapse into indifference, are assuredly responsible in some degree for delaying the changes that must be made before certain economic maladjustments will have been remedied.

Specific Instances of Economic Change.—We return now to the main issue of this section of the present chapter, that is,

[5] *Collier's Weekly*, March 20, 1926.

to the feasibility of altering economic conditions. Probably the best evidence that economic conditions *can* be changed is the indisputable fact that economic changes have been wrought in response to demands that certain maladjustments be remedied. Economic insecurity has been relieved to a large extent, in many countries, by social insurance of various forms; the American problem of immigration has led to the erection of barriers against the influx of foreigners; the inelasticity and insecurity that long characterized our commercial banking system have been remedied, in part at least, by the Federal Reserve Act of 1913 and the Banking Acts of 1933 and 1935; our tariff rates have been modified, time and again, to bring them into line with the views of the administration in power. These and similar economic changes that are described in the present volume and in other works on the subject, are proof positive that society is not powerless in the face of economic maladjustments.

The Method of Approach

Economic Principles and Economic Problems.—Many economists find it convenient to divide their subject into two general groups of items, the first consisting of economic principles and the second of economic problems. To be sure, there is no clean-cut line of demarcation between the two in actual economic life, but there is something to be said for separating them for purposes of study.[6] The subject of *economic principles* relates to an examination of the economic system as it is, with the purpose of discovering the fundamental principles upon which it is based and in accordance with which it *tends* to operate. We refer here to such economic "laws" as the Law of Diminishing Returns, the Law of Supply and Demand, and the Law of Comparative Advantage. Economic principles are comparable to the laws of physics and chemistry, in that they are generalizations that are applicable only under certain stated conditions, and, further, in their freedom from any implication that the system which they describe is a socially desirable system. The purpose of economic principles, then, is merely to describe accurately the workings of our economic

[6] In many of the standard college textbooks on economics, both *principles* and *problems* are treated in a single work. See, for example, Paul F. Gemmill and Ralph H. Blodgett, *Economics: Principles and Problems,* New York, Harper & Brothers, 1937, vols. 1 and 2.

system, granted certain stipulated conditions. One might be a thorough scholar in the field of economic theory, and make great contributions to our understanding of fundamental economic processes, with never an expression as to the merits or defects of the system—just as a student of anatomy might spend a lifetime studying the human body, aiding physicians and surgeons greatly with his discoveries, and yet saying nothing about whether he thought the "human machine" a fine piece of mechanism or a badly bungled bit of creation.

There is no reason, of course, for denying the student of economics the privilege of making appraisals, but this is a privilege that should be exercised in the field of *economic problems*. Economic principles describe the workings of the system, while economic problems deal with the maladjustments of our economic life. The student of economic problems looks about, sees conditions that strike him as being socially undesirable, and proceeds to search for a remedy. This is precisely the sort of thing that has been done in the case of the economic problems that were chosen for treatment in the present volume. In most instances, the authors, in planning and writing a given chapter, have asked themselves such questions as these:

1. What are the indications that a problem exists; that is, what are the symptoms?
2. What are the causes of the maladjustments?
3. What can be done about it?

It will be obvious to the careful reader that the collection, selection, and presentation of the material essential to the understanding of an economic problem inevitably involve a very considerable expenditure of time and effort. It is not our purpose, in this book, to discuss the technique employed in "working up" an economic problem, but it is believed that a critical examination of the problems here presented will give some idea of the various methods of attack that are available. In general, having made a diagnosis of the situation, we may well follow the advice of Professor John Dewey, to "decide upon what we want socially, what sort of social consequences we wish to occur, and then use whatever means we possess to effect these intended changes."[7]

[7] John Dewey, "Social Science and Social Control," in *New Republic*, July 29, 1931, p. 277.

The Use of Theory in Solving Problems.—One of the sad facts about our reformers of economic conditions is that they often set forth upon their careers of reform, and undertake to solve economic problems, without understanding the principles with which the problems or the proposed solutions are tied up. As a consequence of this limited knowledge of economic theory, well-intentioned but misguided individuals regale us from time to time with economic proposals that are highly fantastic. Every business depression yields its crop of plans for the governmental printing of large quantities of paper money to be used in relieving the "money shortage." Repeated exposure of the dangers of monetary inflation has done little or nothing to discourage these champions of "cheap money." And when unemployment descends upon us, we are informed that the *only* way to provide steady work for all is to cut down the length of the working day, no thought, apparently, having been given to the possibility of working full time and thus raising our standards of living.

It is into errors such as these that economic reformers are likely to fall if they approach their task without a knowledge of economic principles. *Current Economic Problems* was written with the thought that it would ordinarily be read by those who understand something of economic theory. We know of no way to find sound solutions for economic problems without recourse to economic principles. We believe, therefore, that the present volume will prove most helpful when its use is preceded by training in theory; that in the usual one-year college course in introductory economics, for example, it can best be used as a text for the *second* term, following a *first* term devoted to the study of theoretical economics.[8] Nevertheless, an attempt has been made here, in the case of each problem, either to explain briefly the economic principles that apply to its analysis and solution, or to refer the reader to particular theories that are treated at some length in all of the standard textbooks on economic principles.

A Plea for Objectivity.—We must not close this introductory chapter without urging the reader to adopt, in so far as he finds it possible to do so, what is often called the "scientific attitude," in his study of economic problems. This does not mean that he

[8] Among the college textbooks which have been prepared for use in this way is Paul F. Gemmill, *Fundamentals of Economics*, New York, Harper & Brothers, 3rd ed., 1939.

need hold himself coldly aloof and remain untouched by the human suffering that accompanies so many of our economic maladjustments, but rather that he should demand factual evidence at every stage of an analysis. He should feel free to reject any and all statements that are presented without the support of either inductive data, or a logically reasoned deduction based upon acceptable premises. In a word, he should be "from Missouri," maintaining a receptive but skeptical attitude, weighing critically every scrap of evidence as it makes its appearance, and finally rendering a judicial decision that is free from preconceptions and personal bias. If this procedure is followed, the reader may rest assured that his study of these selected economic problems will not be fruitless, no matter how promptly he forgets the details and his verdict as to the soundness or unsoundness of the solutions that are proposed.

We are not suggesting that the task outlined above is an easy one. On the contrary, it is most difficult to divorce one's thinking from one's personal background and achieve strict objectivity, when considering matters that are as highly controversial and as important personally as are most economic problems. A young man's attitude toward unionism is likely to be colored by the fact that his father is a manufacturer and has had his authority challenged by union officials; his attitude toward a high inheritance tax may be influenced by the knowledge that he will some day inherit a fortune—or, on the other hand, by the certainty that he will inherit nothing, so that even a hundred-per-cent tax of this kind would mean no personal loss; his impatience with widespread unemployment may be tempered by the fact that he has himself never known real hunger, and by the impression, mistaken but all too prevalent, that it is only the shiftless and lazy who cannot find work.

We repeat, therefore, that the achievement of objectivity, or an "open mind," is not easy, but it is a goal that is well worth striving for. There is great need today, in the world of affairs, for disinterested investigators—for men and women who can be trusted to examine problems of social import in various fields of human endeavor, and to make analyses and propose solutions that are not tinged with self-interest. We ask, therefore, that the reader approach this study of economic problems in the spirit of impartial inquiry, with a firm determination to find out what there is of truth or error in our treatment of some of the outstanding

issues of present-day economic life. We feel confident that this is the spirit that must be adopted if the study is to yield the greatest possible return of pleasure and profit.

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1. In economic life, changes that are made in the name of economic progress are often opposed by some persons. Why?
2. Discuss briefly any social problems that appear to you to have arisen out of the following developments:
   (a) The popularity of motor transportation
   (b) The development of radio broadcasting
   (c) The growth of the motion picture industry
3. What is meant by the term "social science"?
4. "Out of an attempt to remedy a specific social problem, maladjustments of other kinds often arise." Illustrate.
5. "We should be able to assume an interest in economic problems, on the part of all members of society." Discuss this statement, under the headings "business success," "intelligent citizenship," and "general culture."
6. The late Andrew W. Mellon, in an interview on March 23, 1929, was reported to have said: "It is as impossible to change the present distribution of wealth as it is to cause the earth to stop revolving." Compare this statement with the paragraph of Chapter 1 entitled "Man's Control of Economic Conditions."
7. There are a good many members of society who apparently feel that "there is something immoral about interference with economic *laissez faire*." Should not these persons, to be consistent, object to interference with mad dogs, smallpox germs, and weeds in gardens; that is, should we not interfere either always, or not at all, with conditions that are socially objectionable?
8. Indicate the difference between *economic principles* and *economic problems*.
9. In undertaking to make a study of a specific economic problem, what questions would you expect, by the time your study was completed, to have answered?
10. What is the meaning of the "scientific attitude," and why is it important in the investigation of economic problems?

References for Further Reading

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PROBLEMS OF LABOR

2 INDUSTRIAL CONFLICT

IN A CAPITALISTIC INDUSTRIAL SOCIETY, COMMODITIES AND SERVICES ARE PRODUCED UNDER THE CONTROL OF BUSINESS ENTERPRISERS. It is the enterpriser who assembles the factors of production—land, labor, and capital—that are essential to the operation of his business, and assumes responsibility for the profitable functioning of the enterprise. It is he to whom landlords, workers, and owners of capital must look for payment for the use of the several productive agents.

General Interest in Large Product.—The various theories that profess to explain the distribution of income among the owners of land, labor, and capital are in agreement on at least one point, namely, that those who own these factors of production, if they are to be rewarded at all, must be paid out of the total product that results from the use of the productive agents. The larger the output produced with a given amount of land, labor, and capital, the greater the probability of being able to collect a high price for the use of a given agent of production. In the distribution of income, as in geometry, the sum of all the parts cannot be greater than the whole. A factor of production cannot command a high price unless, through its use in combination with other agents, a large addition is made to the total product. Viewed in this way, production appears to be a cooperative enterprise, into which all parties concerned should enter with a right good will and work enthusiastically to attain the largest possible output.

Competition: The Basis of Industrial Conflict.—And yet, in every economic system that operates under the rule of competition there appears to be economic conflict. Its most common manifestation is the disputes that take place between enterprisers and labor, that is, between the employers and their employees. The existence of employer-employee conflict is not difficult to explain. At its roots lies the fact that, though there may be general agreement that society should produce the largest output possible, there is quite likely to be disagreement when it comes

to the distribution of that output. For it so happens that enterprisers may think it desirable to increase their profits by keeping wages down, and labor, on the other hand, may favor an advance in wages that can be had only by encroaching on profits.

The tendency for every man to look after his own economic interests is one that receives abundant encouragement in a competitive society. It is pleasant to be regarded as successful, and success is commonly measured in terms of income. Hence, employers seek large profits and employees high wages; and as a consequence they come to regard their interests as antagonistic —as, indeed, in large measure they are. Thus we find in all competitive economic societies the problem of industrial conflict, which arises from economic antagonism between employers and employees and makes itself known to the general public in the form of strikes, lockouts, boycotts, sabotage, and other militant measures.

Collective Bargaining

Individual *vs.* Group Action.—Industrial conflict, then, appears to be the outcome of the competitive nature of employer-employee relationships. The terms upon which the employers and employees join in productive activities, like the terms which are current in every field of competition, are the result of bargaining. Now bargaining of this kind may be either *individual* or *collective*. In individual bargaining, the terms of employment are arrived at through the employer dealing with his workers *as individuals*; in collective bargaining the negotiations take place between the employer and the workers *as a group*. Bargaining individually, the worker is at a great disadvantage for several reasons, the most significant of which is the fact that to the enterpriser one employee more or less means little, but to the worker a job is a matter of the utmost importance.

When bargaining is conducted on a collective basis, however, this disadvantage disappears. The worker's need for a job is no less urgent than before, but the employer's position is considerably changed. It is no longer a question of having one worker more or less, but of being able to secure a complete labor force or none at all. For collective bargaining means, to use the slogan of the American Federation of Labor, "one for all and all for one." The workers, banded together in a union, delegate to an official (usually the business manager of their organization) the right to bargain for them; and this official, with the authority

to give or withhold the total supply of labor of a given kind, is naturally able to drive a much better bargain than the individual worker trying to bargain for himself. There can be no doubt that collective bargaining, in thus strengthening the position of the wage earner, does much to bring about equality of bargaining power between employers and employees.

Equalization of Bargaining Power.—The social desirability of some degree of equality in bargaining power in employer-employee negotiations becomes apparent when it is realized that the alternative is to leave the economic fate of industrial workers almost wholly in the hands of their employers. And yet there are still a good many employers in America who hold that effective unionism is objectionable, and who oppose collective bargaining. According to the late Chief Justice Taft, such employers say, in effect: "It is my legal right to manage my business as I choose, to agree to such terms of employment as I choose, to exclude from my employment union men, because I don't approve of the tenets of the union, and to maintain a family arrangement of my own. I do fairly by my men; I pay them what I think is right, and they will not complain unless some outside union agent interferes. I run a closed non-union shop, and I am happy and propose to continue happy." Mr. Taft, who can scarcely be thought of as a radical, referred to the employer of this type as "the bourbon, the man who never learns anything and never forgets anything. . . . This man is far behind in the progress of our social civilization. . . . He does not recognize that we have advanced beyond the state in which employers and employees are mere laws unto themselves."[1]

Labor Organization in the United States.—The principle of collective bargaining has found very general acceptance in most of the older industrial countries, where the spirit of extreme individualism appears to be on the wane. In England, for example, not only are the workers encouraged to organize, but their unions are used in the furtherance of projects established by governmental action, such as works councils and unemployment insurance. In the United States, labor organization has not been so widespread. Indeed, in certain industries (such as iron and steel manufacture, and the production of electrical goods and automo-

[1] These two quotations are from an article entitled "Collective Bargaining," by William Howard Taft, in Daniel Bloomfield's *Problems of Labor,* New York, H. W. Wilson Company, 1920, p. 213.

biles) there was nothing that could be called effective unionization prior to 1936, when the Committee for Industrial Organization—which in 1938 adopted the name Congress of Industrial Organizations—began to unionize the workers in these fields.

The American Federation of Labor, the oldest group of organized workers in the United States today, has a membership of some 3,500,000 dues-paying workers. This number includes workers in hundreds of trades. The Congress of Industrial Organizations—popularly known as the C.I.O.—claims 3,790,000 members. There are several important groups not affiliated with either the A.F. of L. or the C.I.O. The railroad conductors, engineers, firemen, and trainmen make up the four powerful "Railroad Brotherhoods," with a combined membership of at least 300,000, and are directed by exceptionally well-informed leaders. Another strong union, once affiliated with the C.I.O. but now independent, is the International Ladies' Garment Workers' Union, with 250,000 members. The Trade Union Unity League, a communist organization, has a membership of approximately 60,000. The Industrial Workers of the World, which aims to "take possession of the earth and the machinery of production, and abolish the wage system," has about 10,000 members, largely among the itinerant harvest hands and lumber workers of the West. Other non-federated labor groups in this country have a total membership of some 400,000, but these organizations are not of sufficient size individually to warrant special mention. We have, then, according to the best estimates that are available, about eight million union workers in the United States. The workers in this country who might properly be termed "organizable" total about thirty-five millions.

Union Aims and Methods

Recognition of the Union.—There can be no collective bargaining, of course, until the employer has agreed to deal with his workers on a group basis. Many long and bitter strikes have been fought in the effort to establish the right to bargain collectively. Once this concession is granted to the workers, the union seeks, through its authorized representatives, to secure as great advantages as are obtainable in the way of high wages, short hours, and favorable working conditions. These three items form the essential features of the "trade agreement," or "labor con-

tract," the formulation and acceptance of which is the prime object of all well-regulated unions.

The Trade Agreement.—The trade agreement, which is usually though not always a written contract, is a statement of the terms of employment upon which the members of the union are to work. A trade agreement may extend over a short period, such as six months, or it may establish the working arrangements that are to prevail for several years. Sometimes it consists of a contract between the union and a single concern, but quite often it sets forth the union's relations to all employers in a given industry within a specified district. Whatever variations may exist in these respects, it is customary for the trade agreement to deal with those phases of the employer-employee relationship that have already been mentioned, namely, wages, hours, and working conditions.

Standardization of Wages, Hours, and Working Conditions.—Of these three items but little need be said other than to point out that it is quite understandable that workers should desire high wages, short hours, and working conditions that insure safe, pleasant employment, and that lead to strength rather than weakness in future collective negotiations. To this end, the members of a union agree upon a standard wage, a standard day's work, and standard working conditions having to do with sanitation, discharge, apprenticeship, and a host of other matters. By adopting the principle of standardization in regard to such items, and refusing collectively to accept terms less favorable than those specified, the workers are able to avoid the disastrous competition that often accompanies individual bargaining.

The Closed Shop and Open Shop.—But it is one thing to get employers to agree to deal with their workers as a group, and quite another to achieve the acceptance and actual execution of terms of employment that are satisfactory to the members of the union. Experience demonstrates that a labor organization, if it is to win and hold the respect of business enterprisers, must be able to make a show of strength when the occasion demands. This display will be all the more imposing if the employer is confronted with the fact that his entire force of workers of a given type will go on strike if their demands are not met. Hence it is that labor leaders do their best to put into operation the "closed shop," which means that no union man is permitted to work in an establishment that hires non-union men in his particular trade or craft. Employers, on the other hand, often insist upon the right

to run an "open shop," which is one that permits union and non-union men to work side by side, presumably without discrimination.

From the point of view of sound unionism, the closed shop is obviously superior, since it means that a failure to come to terms with the union will result in the employer losing all of his workers in a given craft, down to the last man. Defiance of the union by an employer functioning under open shop conditions might involve the loss of a part, say a half or two-thirds, but not the loss of all of his employees. As we shall see later, it is next to impossible to carry on effective collective bargaining in the absence of the closed shop. Since this is true, it follows that most unions insist upon the establishment of the closed shop just as soon as they have developed sufficient strength to enforce this demand.

The Strike and the Boycott.—The existence of a closed shop is a powerful aid to a union in securing the adoption and fulfillment of a trade agreement favorable to the workers. But there are other measures that can be resorted to when necessary. The most effective weapon in the hands of the union is the strike, and, as has been suggested, its effectiveness is enhanced if the union officials can call away from their jobs all workers of a given kind in an establishment, as is the case under closed shop conditions. The boycott is an organized refusal on the part of union workers, members of their families, and union sympathizers in general, to buy commodities or services from business concerns that have been pronounced "unfair" in their dealings with labor.

Sabotage: An Industrial "Racket."—Yet another instrument that may be used to convince the employer that it would be well to grant the demands of the union is "sabotage." Webster defines sabotage as "malicious waste or destruction of an employer's property by workmen during labor troubles." The workers, instead of going out on strike, may decide to *strike on the job*; that is, to remain at work and yet see to it that the employer feels their displeasure in a way that hurts. A monkey wrench slips into a costly machine and wrecks it, a batch of raw material is ruined by the addition of a quantity of acid, or a fire hose gets turned on mysteriously and soaks beyond all hope a thousand dollars' worth of finished goods. These and similar "accidents" that are calculated to bring a balky employer to terms cannot be condemned too vigorously. They do not constitute legitimate industrial warfare. Rather, they are on a par with the predatory tactics of the modern racketeer who destroys the property of any business man who

refuses to buy "protection." In fairness to organized labor, it must be said that there are very few unions that deliberately engage in practices of this kind. On the other hand, there are likewise few that would not promptly and strenuously employ the strike and the boycott if their aims could not be realized through more peaceful measures.

Industrial Conflict and Public Welfare

The Attack on the Closed Shop.—The effects of union activities upon public welfare may now be examined briefly, since any sound appraisal of unionism must be based largely upon the social consequences of the labor movement. What, for example, can be said in behalf of the closed shop, which has been so bitterly attacked by certain employers? The answer given by labor leaders and by disinterested students of labor problems is that effective collective bargaining appears to be dependent upon the adoption and enforcement of the closed shop principle.

The Weakness of the Open Shop.—It has been proved, time and again, that the open shop does not provide the strong organization and unity of action that are essential to collective bargaining. If non-union men are permitted to work in the same establishments as union workers, sharing in all the benefits of high wages, short hours, and satisfactory working conditions that have been won by union action, there is but little incentive to take out or retain membership in the union, since union members have no privileges that are not enjoyed by non-union workers, except the rather doubtful privilege of paying dues. Thus the attempt to maintain an open shop leads almost inevitably to loss of membership, and consequently to loss of power in collective bargaining, since the latter is based ultimately upon the ability to wage a battle in case of necessity. Many a union has come to grief through the blighting influence of the open shop, or has saved itself from ruin only by shifting to the closed shop basis before it was too enfeebled to make the move.

The Closed Union *vs.* the Open Union.—The advocates of collective bargaining sometimes insist that the opponents of the closed shop are confused in their thinking—that they are wasting their time and effort in fighting an essential and socially desirable device of unionism, the closed shop, whereas in reality they should be concentrating their fire on the "closed union." For the closed union holds grave possibilities of being socially harmful,

since it may be used to restrict the number of workers that shall be permitted to enter a given trade, and thus bring about an artificial level of wages.

The "open union" is one which aims to enroll in its membership all workers belonging to a craft or trade, such as bricklayers, carpenters, or cigarmakers. Membership is made attractive by the establishment of small initiation fees and low annual dues, and the test of craftsmanship may consist merely of a man's ability to secure a job from an employer. The closed union, on the contrary, seeks to limit its membership by charging high initiation fees and dues, and sometimes by requiring that the candidate pass a rigid examination in the craft in which he claims proficiency and be approved by vote of the existing membership of the union. It will readily be seen that requirements such as these can be made the means of exclusion from the union, whenever its members feel that it is unwise to add to its numbers. The result is a limitation upon certain types of labor, and exceptionally high wages for those types, but labor in general does not share in these wage benefits. The public, of course (including all labor that is not similarly organized), pays the bill, just as the public pays whenever an enterpriser in a monopoly position restricts the supply of his commodity and thus forces up the price. The closed union, then, may be just as injurious to public welfare as the monopoly control of commodities or services. To control the situation, the closed union must, of course, include within its membership a large proportion of the total workers in the trade. This statement is applicable also to the open union, since neither type of union could hope to maintain a closed shop if large numbers of competent non-union workers were looking for jobs.

The Open Union with the Closed Shop.—It is the open union operating under the closed shop principle that most students of labor problems regard as the best form of labor organization that has yet been devised. If the union is genuinely open, it has no limiting influence upon the supply of labor. If the supply should be small and wages high as a consequence, there will be a tendency for workers to be attracted to the trade; and if all are to find employment the wages will have to come down, unless we suppose an increase to have taken place in the demand for labor of this kind. It is in this respect that the open union is socially preferable to the closed union, as was noted in the preceding paragraph.

Having been taken into the union, the new members are perfectly free to work in the closed shop. Indeed, the union frequently acts as an employment agency for its members. Thus the combination of open union and closed shop does not deny an employer the privilege of engaging any worker who is willing to acknowledge labor allegiance to the extent of joining the union and paying dues. What it does, rather, is to set up uniform conditions of employment, make possible collective bargaining, and insure that all who benefit by the union's activities shall have a part in bearing its expenses. In a word, it provides a self-supporting agency through which the worker is enabled to overcome the handicap which he suffers when forced to bargain as an individual.

It will be well, at this point, to emphasize the fact that the open union with the closed shop cannot hope to win for the workers, at a given time, anything more in the way of favorable wages, hours, and working conditions than would tend to come to these workers *in the long run* and under *competitive conditions* even in the absence of a union organization. But this, after all, is a good deal. Readjustments which under individual bargaining might be effected in the "long run" can sometimes be made in the "short run" through collective bargaining; and competition, which tends to become sluggish when there are great inequalities in bargaining power, is stimulated into action when workers organize an open union and enforce the closed shop principle. Economic theory speaks of the tendency of wages to equal the marginal productivity of the worker. An open union with a closed shop does much to convert this tendency into a reality. Functioning properly, it enables the worker to secure his *full competitive wage*, which he can seldom secure without collective action. Similarly, it enables him to command his full competitive share of short hours and good working conditions. Collective bargaining of this kind is valuable, then, in obtaining for the worker those benefits to which the existing conditions of supply and demand entitle him—benefits which he is usually unable to secure, however, when he is compelled to contend individually with the superior forces of the employer.

Limitation of Output.—Unions are often charged with restricting output by insisting that their members turn out no more than a specified number of units of product per day, or, again, by fighting for a shorter working day or week. It is true, unquestionably, that unions do endeavor to cut down the amount of time that workers shall be compelled to give to industry. Owing largely

to union pressure, working hours have been reduced from twelve to ten, and again from ten to eight in a great many businesses, and there is much talk of still further reductions. In some instances, indeed, these further reductions have already been made. The United States Bureau of Labor Statistics reported, for example, that in 1928 there were thirteen crafts in this country that were on the 40-hour week in one or more cities. With the introduction of the so-called "New Deal" in 1933, the working week of American workers in general was shortened materially, in some instances being reduced to thirty hours. According to the National Industrial Conference Board, the *average* actual working week of the employees in twenty-five manufacturing industries was, in 1937, 39.1 hours. In most trades it is probable that a shortening of the working day and week did not bring a proportional loss in production. It is certainly true, as has been proved by actual tests, that a reduction in working time may result in a larger rather than a smaller output per dollar of wages paid. There is serious doubt, however, that the working week can be reduced to thirty hours without loss of output; but in any case it seems reasonable that the workers should share in industrial progress not only through the receipt of larger wages, but also in the enjoyment of greater leisure. This, at any rate, is the stand taken by labor leaders, and it is one that is not easy to combat.[2] The 30-hour week now has the official endorsement of organized labor in America.

But, assuming agreement as to the number of hours to be worked, should not each worker be expected to produce his maximum output per hour or day? The business man's reply is usually an emphatic affirmative, but the spokesmen for the unions raise several objections to this conclusion. They point out that it is the duty of the union to safeguard the business interests of *all* its members; that if every worker produced to the utmost of his capacity the employer would try to make the output of the best worker the standard task for the group; and that under these conditions the average worker would be "sweated"—that is,

[2] In 1919, 12 per cent of the wage earners in manufacturing plants in the United States were working 60 hours a week; 48.6 per cent, 48 hours; and 12 per cent, only 44 hours. It has been estimated that the working time of industry as a whole in this country was shortened by six hours a week in the twenty years preceding 1919. Between 1919 and 1933 there was a slight further decrease, amounting to one and one-half to two hours per week.

worked far beyond a reasonable point, and perhaps beyond his powers of endurance. The remedy, from the union point of view, is standardization of task, and this means almost necessarily a standard task that can be attained by the average worker. It is better, the unionists believe, for a few men to be underworked than for many to be sweated.

This argument may not appear wholly convincing to a consuming public that has to pay somewhat more for its commodities and services under union regulation than would be charged if employers were free to drive their workers. But unionists can point to many instances of exploitation of labor in the absence of standards set up and enforced by collective bargaining. In the face of the apparent necessity for the protection of workers in this respect, it is difficult to make out a strong case against the standard task, unless the standard set is ridiculously low. So long as there is conflict of interest between employers and employees, the workers can scarcely be expected to surrender a powerful weapon of defense such as standardization has proved to be, even though its retention may involve some loss to society at large.

Business Men's Practice of Limitation.—Restriction of output, incidentally, is a subject in which some business men could easily give lessons to workers. It is certainly not demonstrable that enterprisers feel impelled always to turn out the maximum amount of product. On the contrary, it is a very common practice —and, it may be added, a thoroughly "respectable" one in business circles—to manipulate output in a manner dictated by the enterpriser's economic interest, that is, on the basis of profit. If a large output gives promise of the maximum profit, a large output will be produced; but if more is to be made by restricting output, business men ordinarily do not hesitate to engage in restrictive practices. This statement is not intended by way of justification of limitation of output by either employers or employees. It is merely a statement of fact, designed to indicate that if standardization by unions *incidentally* brings about restriction of output, it should not on that account be condemned too heartily until we have successfully disposed of *deliberate* limitation of output on the part of business enterprisers.

One form of restriction practiced by business men is the purchase and "shelving" of patents on new machinery which, if put into use at once, would reduce the costs of production of certain

commodities and permit their sale to the public at lower prices.[3] The reason for wishing to delay the introduction of the cheaper processes lies usually in the existence of capital (that is, machinery) which has in it some years, and often many years, of further usefulness. It is often "good business," from the enterpriser's point of view, to postpone the use of the improved device until the existing equipment has worn out, even though the postponement is costly to the consuming public.

Labor's Opposition to New Machinery.—A parallel to this type of restriction is found in the opposition of unionists to the introduction of labor-saving devices that threaten to take away their jobs, or that at best are likely to force them to accept wage reductions. Thus, the Journeyman Stone Cutters' Union fought bitterly the mechanical planing of stone, the Glass Blowers' Union opposed the introduction of the Owens bottle-making machine, and the American Federation of Musicians has battled and is still battling against the "canned music," recorded and reproduced by mechanical devices, that has to a large extent supplanted theatrical orchestras.

It may be that methods will be found for the gradual replacement of old machinery by new, with only slight loss to business men through the scrapping of usable capital, or to labor through the obsolescence of acquired skill. On this point we shall have more to say in the following chapter. For the present, it is not inappropriate to refer to the old proverb, "What is sauce for the goose is sauce for the gander," and to suggest that it is scarcely consistent to condemn skilled workers for opposing the installation of new machinery unless we are equally critical of business men who buy up and smother patents on new and better processes in order to avoid the sudden obsolescence of industrial capital.

Unemployment and Restriction of Output.—Another cause of limitation of production as indulged in by both organized and unorganized workers, is the fear of being laid off temporarily. This, again, is a subject with which we shall deal in our treatment of economic insecurity. But it may be observed here, in passing, that to most industrial employees, union and non-union alike, the paramount issue in life is getting and holding a job. This being true, it is not surprising that the possibility—even the remote possibility—of lay-off through a lack of work should lead workers

[3] See, in this connection, Floyd L. Vaughan, *Economics of Our Patent System*, New York, The Macmillan Company, 1925, chap. 6.

to indulge in "soldiering," that is, producing less than could be produced in a given time, in order to make the job last just as long as possible.

It would be a self-denying worker, indeed, who deliberately "worked himself out of a job" by producing the maximum output, when by lessening his efforts he could be sure of drawing wages over a longer period of time. Society suffers, of course, by the adoption of such tactics; but perhaps a society that does not attempt seriously to solve the problem of lay-offs deserves little sympathy if its neglect of the problem carries the penalty of high prices through limitation of output. At any rate, as we have noted, soldiering on the job in order to delay the evil day of unemployment is by no means confined to unionists. It is practiced consistently by all workers who believe in that cardinal principle of the competitive system—that it is the duty of every member of society to seek first his own self-interest. Doubtless all restriction of output is bad, whether practiced by employers or employees, but a means has not yet been found whereby restriction can be abolished in an economic system motivated by a desire for individual profit.

The Use of the Strike.—The strike is a concerted withdrawal of workers from an establishment, and is a move designed to force the employer to grant the employees better terms than those under which they have been working, or to compel him to withdraw an unpopular ruling such as a cut in wages or an increase in hours. The strikers are always hopeful that their action will cause the employer to concede the point at issue and thus make possible the resumption of business relations and operation of the plant. A strike does not mean, then, that those who take part in it have relinquished all claim to their jobs. On the contrary, workers on strike invariably regard the temporarily abandoned jobs as belonging distinctly to them, and they object most strenuously to any attempt of the enterpriser to replace them with a new working force. Probably no one in the industrial world is more thoroughly despised than the "strike breakers"—the workers who are sometimes hired temporarily by an employer in the effort to discourage the strikers and get them back to work on his own terms.

Public Attitude Toward the Strike.—Non-union workers have been known to go on strike; but since success in this phase of industrial conflict demands united action, it is among the unionists that strikes are most common and most effective. The

strike is the most spectacular form of industrial warfare; and since the workers, in going on strike, take the initiative and act as aggressors it is perhaps to be expected that the general public should jump to the conclusion that strikers are troublemakers, that their demands are probably unreasonable, and that they are entitled to little sympathy. This is particularly likely to be the case for the reason that all that the public learns about a strike comes ordinarily from newspaper reports, and these reports are more likely to reflect the indignation of the outraged employer and the irritation of the local police than to present an impartial and dispassionate account of the conditions giving rise to the strike.

The attitude of society toward the strike and strikers is affected by the fact that recourse to this weapon often brings inconvenience, and sometimes actual suffering, to the consuming public. An actors' strike means closed theaters, a railway workers' strike brings interruptions in transportation, a miners' strike forces the use of bituminous coal and coke in place of the desired anthracite, and so on. Particularly in the case of public utilities is it easy for incommoded consumers to get the notion that the strike is an evil institution, and that those who invoke and prosecute it are enemies of society. Whether the public's interest in securing an uninterrupted supply of commodities and services should lead to the outlawry of the strike, is a question to which we shall give some attention later in the present chapter.

Economic and Human Costs of the Strike.—The inconvenience experienced by consumers when workers go on strike is only one of the many costs imposed upon society by industrial strife. This is a form of cost that cannot be measured with any degree of accuracy. Probably we are justified in suggesting that strikes do not, as a rule, cause the public any great amount of suffering. And yet the possibilities of injury to health through the non-delivery of such essentials as milk or coal, and to life and property in the event of a strike by the police or other public servants, cannot be ignored.

In the newspaper reports of strikes, much is usually made of the economic costs borne by workers in the loss of wages and by employers in the loss of profits. These costs are often exaggerated, and yet, despite the absence of exact data, we know that they run into the millions. It has been estimated, for example, that strike losses for the years 1915 to 1921, inclusive, totaled some two billion dollars, of which $750,000,000 represented wages that

workers would have received had they stuck to their jobs, and $1,250,000,000 the loss suffered by employers.[4] Though these losses bulk large in the aggregate, they are not so imposing when spread over the years in question and divided among some thousands of employers and hundreds of thousands of workers. Nevertheless, since the figures represent pure loss, they suggest the economic desirability of the elimination of strikes.

It should be noted that the years cited are not normal ones, since they fall within the war and early post-war period. During this seven-year period, there was a yearly average of about 3000 strikes in the United States. Ordinarily, the average has been about half that number, and for the years 1927 to 1932, inclusive, the annual average was only 770. Strike figures in 1937 were the highest in two decades. In that year there were 4740 strikes in this country, with 1,860,621 workers involved, and a loss in working time amounting to 28,424,857 man-days.

Yet another social cost chargeable to strikes is the loss of life that occasionally accompanies militant activities in industry. When strikers are lined up on one side of the contest, straining every nerve to win a victory that will insure satisfactory, remunerative jobs, and armed guards, detectives, and strike breakers are arrayed against them, it is no easy matter to prevent violence. Indeed, in view of the opportunities for trouble that such a situation presents, surprisingly little violence occurs in connection with strikes. There are, to be sure, such bloody encounters as the "Ludlow massacre" and the "Herrin massacre," in which there was wholly inexcusable loss of life.[5] In the main, however, American strikes have been conducted with comparatively few fatalities.

The Industrial Lockout.—The "lockout" is much less spectacular than the strike, but it constitutes an act of aggressive warfare on the part of the employer, just as the strike is an act

[4] J. H. Hammond and J. W. Jenks, *Great American Issues,* New York, Charles Scribner's Sons, 1921, p. 99.

[5] At Ludlow, Colorado, on April 19, 1914, a group made up of militia and mine guards—the latter in the pay of the Colorado Fuel and Iron Company—opened fire on a tent colony of striking miners, and a few hours later burned these temporary homes of the miners to the ground. Twelve children and two women lost their lives in this "massacre." At Herrin, Illinois, during a strike against the Southern Illinois Coal Company, three union workers were killed in a pitched battle between strikers and mine guards on June 21, 1922. On the following day sixteen of some sixty strike breakers who had surrendered were killed by an armed mob, despite the fact that they had been promised safe conduct out of the county.

of aggression initiated by the workers. In the lockout the employer closes his doors and does not open them again until the workers come to him suing for peace and ready to accept his terms of employment. This action, it will be observed, has precisely the same social consequences as a declaration of strike by the workers; that is, it immediately puts a stop to production and thus interferes with society getting the goods that it wants. The strike and the lockout are alike, moreover, in purpose. The object of each is to force the party against whom it is directed to agree to terms dictated by the aggressor, whether the latter be an employer or a union. The strike and lockout are so similar in purpose, in method, and in social consequences, that it is scarcely possible, with consistency, to oppose one and at the same time endorse the other.

Employer Attitudes Toward Unionism

The Open Shop Movement.—We have already noted the fact that unionism is accepted as a matter of course in England and France. In the United States there are many employers who regard collective bargaining as desirable and inevitable, but this attitude is far from universal. Much of the opposition to unionism has been passive, but some employers have taken an active part in the fight by joining in the "open shop campaigns" waged by such organizations as the Chamber of Commerce of the United States and the National Metal Trades Association. By means of addresses made by paid speakers and the distribution of tons of printed matter, the "American" open shop has been lauded and the "un-American" closed shop roundly condemned.

To the charge that the closed shop is un-American, the unionists retort that, on the contrary, it is as distinctively American as any institution could possibly be. They insist that there can be nothing even approximating democracy in American industry unless the workers are strongly organized, and that powerful unions are out of the question in the absence of the closed shop. They argue, further, that the closed shop is democratic and American because it forces all who benefit by union activities to pay dues, and thus to contribute to the costs of achieving progress; whereas the open shop allows the unionists to pay the bills, while non-union workers, who are equally well off financially, enjoy the benefits gained through union efforts but make no payments.

In these verbal disputes, it would seem that the unionists have the better of the argument. They have found the weak spot in the

armor of those employers who profess to believe in unionism but who specify that it must be a unionism which, by its very nature, is so weak as to be virtually useless. When employers talk about endorsing unions and yet insist upon the open shop, they indicate that they are looking for credit without performance—that they are seeking a reputation for friendliness to organized labor while in reality they are antagonistic to the development of union power—for effective unionism is practically impossible in conjunction with the open shop.

The Company Union.—The "employee representation" movement, which has been developing in the United States during the past twenty years, is regarded by many as an attempt to weaken unionism of the militant type by the introduction of a harmless variety of organization known as the "company union." The company union is one that comes into being with the full consent of the employer, and it is ordinarily initiated and financed by him. Under company unionism, or employee representation (for the terms may be used interchangeably), the workers in a given establishment elect representatives from among their number to meet at stated times with representatives appointed by the employer. At these meetings it is possible to raise questions of hours, working conditions, and (in rare instances) wages. The theory is that through these friendly councils the wishes of the workers will become known, misunderstandings cleared up, abuses remedied, and a spirit of cooperation built up.[6]

A survey of the situation shows that company unionism has been successful in improving labor relations in some instances, and has met with dismal failure in others. The movement is too young to warrant a prediction as to its future progress or decline. It has been warmly endorsed by many employers and by some disinterested students of labor, but has been openly and bitterly condemned by the independent unionists. The strongest argument against the company union is the impotence of its members in the face of opposition on the part of the employer. As the name "company union" indicates, this type of organization is the creature of the employer. It is not free, as is the independent union, to press its claims when they run counter to the employer's wishes.

Employee representation does provide a means of frequent intra-plant conference, which may be a valuable aid to production

[6] The company union is examined in detail in Paul F. Gemmill, *Present-Day Labor Relations,* New York, John Wiley & Sons, Inc., 1929, chaps. 3-8.

and the maintenance of good will. It lacks, however, that prime essential of true democracy—"power in the hands of the people"—and it is largely because the company union leaves its members powerless in time of emergency, and dependent upon the benevolence of the employer, that it has aroused the enmity of thoroughgoing unionists. The unionists, moreover, regard the employee representation movement as a device for undermining strict unionism. They have watched with apprehension its gain in adherents. According to the best estimates available, workers to the number of about 2,500,000 now belong to company unions in the United States.[7] This does not mean, however, that these are workers who have deserted from the ranks of trade unionism and gone in for company unionism. They are, for the most part, workers who were formerly unorganized and who now appear under the company union banner because their employers have put into operation systems of employee representation. Nevertheless, the orthodox unionists regard company unionism as a threat to independent unionism, and have been fighting it vigorously ever since its inception.

The "Yellow-dog" Contract.—One very objectionable feature of certain employee representation plans, from the trade union point of view, is the requirement that every worker sign a contract, agreeing that, while in the employ of the concern, he will not join a trade union, and sometimes even promising not to associate or confer with union leaders or members during his term of employment. It is to this type of contract that unionists have given the name "yellow dog," because (to quote an official statement of the American Federation of Labor) this contract, "like the proverbial alley cur, is a menace to the community in which it exists."[8] Whether or not this statement is strictly accurate, there can be no doubt that the yellow-dog contract is a distinct menace to unionism. Not only may a company, by virtue of this contract, discharge an employee who has violated his agreement by joining a union, but employers have succeeded in having court injunctions issued, restraining union representatives from attempting to organize their employees, on the ground that to undertake such organization would be an attempt to induce breach of contract.

[7] *Labor and the Government*, by a Special Committee of the Twentieth Century Fund, Inc., New York, McGraw-Hill Book Company, Inc., 1935, p. 79.

[8] *Report on Proceedings of Forty-seventh Annual Convention*, October, 1927, American Federation of Labor, Washington, D. C., p. 291.

The leaders of labor promptly recognized the fact that if the yellow-dog contract were allowed to stand, and if it were used to prevent union organizers from carrying on their work, it would constitute a real blow to unionism. Hence, they have marshaled their forces against it, and have been able in this struggle to enlist on the side of labor the hearty support of a large part of the general public. A half-dozen states passed laws declaring the yellow-dog contract unlawful. Several state supreme courts pronounced such legislation constitutional, but others declared it unconstitutional. The Supreme Court of the United States, in passing on a similar issue in 1917 and again in 1921, apparently upheld the legality of the yellow-dog contract, basing the decisions on the "freedom of contract" provisions of the Constitution.

In 1929 and later years, many of the states passed laws which, while they did not forbid the use of yellow-dog contracts, made such contracts unenforceable in the courts. The Norris-La Guardia Act of 1932 included anti-yellow-dog and anti-injunction provisions, which have not yet been tested in the United States Supreme Court but are generally believed to be constitutional. The National Labor Relations Act, passed in July, 1935, was aimed in part at eliminating the yellow-dog contract from the field of industrial relations. This Act was declared constitutional by the United States Supreme Court in 1938.

The Labor Injunction.—We have referred to the use of judicial injunctions in connection with the enforcement of the yellow-dog contract. This is one of the most recent and most serious applications of the injunction to labor disputes, but it is, after all, but one of the many uses to which the "labor injunction" is being put.

"Intended originally to protect property from irreparable damage during a strike or boycott, the injunction has been called upon to perform a much wider service. Union workers and officials have at times been forbidden, by court order, to urge non-unionists to join a union even in the absence of a 'yellow-dog' contract, to picket, to publish information regarding the progress of a strike, to pay strike benefits, or to perform any other act which might, in the opinion of the court, lead to certain undesirable results. Obviously, injunctions of this type, if observed, destroy almost completely the power of the strike; for employers can always find accommodating judges ready to issue injunctions that will bring all strike machinery to a stop. One of the most serious consequences

of this alleged abuse of the power to enjoin is a widespread loss of confidence in the integrity of the courts. It is getting to be a commonplace among working people that the courts and the police authorities are always to be found on the employer's side in an industrial dispute."[9]

The growing use of judicial injunctions in industrial conflict has been a source of great anxiety to labor leaders. The Norris-La Guardia Act of 1932, to which we referred in our discussion of the yellow-dog contract, is sometimes called the "Norris-La Guardia Anti-Injunction Act," because its provisions restrict the use of injunctions in industrial disputes. This Act prohibits the issuance of restraining orders except under unusual circumstances, and then for periods longer than five days. No injunction may be granted without an oral hearing in open court. A person charged with contempt in connection with the violation of an industrial injunction is entitled to trial by jury, unless the contempt was committed in the presence of the judge, and he has a right to be tried by a judge other than the one who issued the injunction. There are further provisions in the Act designed to protect the workers' rights in labor disputes.

If this law is upheld by the United States Supreme Court, it should solve the problem of the yellow-dog contract as well as that of the labor injunction, since the effectiveness of the yellow-dog contract is largely dependent upon the right to enjoin.

"Section 7a" and Its Successor.—The National Industrial Recovery Act, passed in June, 1933, contained a provision which became widely known as "Section 7a." This section of the Act granted to workers "the right to organize and bargain collectively through representatives of their own choosing," and specified further that "no employee and no one seeking employment should be required as a condition of employment to join any company union or refrain from joining, organizing or assisting a labor organization of his own choosing." Labor believed that this measure would strengthen the unions already established and bring into existence many new ones. It did temporarily have this effect, but it also stimulated the growth of the independent unions' great rival, the company union. Finally, before it was clear whether Section 7a was to be a blessing or a scourge to organized labor, the Act was declared unconstitutional by the Supreme Court on May 27, 1935.

[9] Paul F. Gemmill, *Present-Day Labor Relations*, p. 17.

However, the spirit and much of the substance of Section 7a were embodied in the National Labor Relations Act, which was passed in July, 1935. This Act, indeed, is written in stronger terms than Section 7a. It prohibits employers from interfering in the organization of agencies for collective bargaining, and thus discourages company unions. It outlaws the yellow-dog contract. It requires an employer to bargain with the representatives of his employees. It provides for administration of the law by the National Labor Relations Board, which has the power to investigate, to settle disputes, to issue orders to employers, and to have these orders enforced by the federal courts. The National Labor Relations Act should be of greater assistance than Section 7a to independent unions. Perhaps for this very reason, it has been bitterly assailed by many employers.

Federal Legislation on Wages, Hours, and Child Labor.—The Fair Labor Standards Act of 1938 (often referred to as the Wages and Hours Law) became effective on October 24 of that year. Its purpose is to protect, to some extent, low-income workers who find it especially difficult to protect themselves because they lack bargaining power—or, as its sponsors are fond of saying, the Act aims to put "a floor under wages and a ceiling over hours."

The Act makes it unlawful for an employer whose products move in interstate commerce to pay less than 25 cents an hour, or to work an employee more than forty-four hours a week without payment of "overtime" in cash at the rate of "time and a half." After one year, the law reduces the maximum hours to forty-two a week, and raises the minimum wage to 30 cents, and this process continues until, at the end of seven years, the maximum hours will be forty a week and the minimum wage 40 cents an hour. However, the administrator of the Act is empowered to appoint industrial committees to investigate conditions in specific industries and, upon recommendation of such committees, to order more rapid decreases in maximum hours or increases in minimum wage.

The Act also legislates on the subject of child labor, specifying that in industries engaged in interstate commerce no child under sixteen years of age may be employed, and none under eighteen years may be employed if the work is "hazardous or unhealthy."

It is estimated that the Act will affect, in the first year of operation, some 750,000 workers as regards wages, and about 1,500,000 in the matter of hours. As time passes, the progressively

lower maximum hours and higher minimum wage will bring additional groups of workers under the protection of the law. However, this Act, like the Social Security Act which we shall discuss in Chapters 3 and 4, falls far short of universal application. For it exempts from the provisions of the law, employees engaged in administrative, executive, professional, local retailing and outside selling activities; employees of retail or service establishments when predominantly intrastate in character; seamen, fishermen, agricultural workers, employees of air transport companies, street car or bus lines; and certain other businesses.

An immediate reaction to the enforcement of the Act was the discharge of some extremely low-paid workers in the pecan-shelling industry (which had been paying as little as five cents an hour, and from $2.00 to $2.50 for a full working week), and in certain tobacco plants, lumber mills, and clothing factories, chiefly in the South. There will doubtless be other permanent lay-offs in industries which find it impossible to pay the minimum wage. There is also the possibility that the enforced higher wages will bring about the invention of labor-saving devices which will lead employers to employ more machinery and fewer workers. On the other hand, the minimum wage will unquestionably strengthen the hand of socially minded employers who, though anxious to pay their workers a fair wage, have been unable to do so because of the cut-throat competition of "chiseling" enterprisers in the same lines of production.

The degree to which the Fair Labor Standards Act will be able to alleviate the economic misery of our less privileged workers cannot be determined until the law has been in force for some years. The goal—a forty-hour week at a minimum weekly wage of $16.00—seems modest enough to those who think in terms of an "American standard of living," and who realize how little can be purchased with an annual income of $832—and this figure assumes that the worker has steady work throughout the year. If consumers find that the Act causes them to pay higher prices for goods than in the past, they may perhaps console themselves with the thought that their individual loss is a social gain. From the social point of view, it may well be argued, an industry which does not pay its workers a decent wage is a liability rather than an asset, and may well be dispensed with.

Craft *vs.* Industrial Unionism.—Unionism in the United States has been predominantly of the "craft" type, with workers of

a given craft or trade joining forces with their fellow craftsmen in a union that aims primarily at protecting the interests of the workers in this particular craft. The American Federation of Labor has encouraged this type of organization, with each union made up of workers who do a specific kind of work. The result has been separate unions of bricklayers, carpenters, machinists, cigarmakers, and a host of other kinds of workers.

In contrast to craft unionism is "industrial" unionism. An industrial union includes every man and woman working in an industry, regardless of the kind of work the person does. The United Mine Workers of America is an outstanding example of the industrial union. On its membership rolls are the names of miners, pumpmen, electricians, carpenters, and workers of many kinds in and around a mine. Just as the closed union shop is superior to the open shop in bargaining power, since it can call out *all members of a trade* working in an establishment, so the industrial union is stronger than the craft union when it comes to a struggle involving the strike. For the industrial form of unionism makes it possible to call out *all workers in a plant* against which war is being waged, and not the members of a craft only.

Foremost in the movement to organize the workers along industrial instead of craft lines is John L. Lewis, president of the United Mine Workers of America. In 1935, he and the leaders of eight other large unions formed the Committee for Industrial Organization, which is now known as the Congress of Industrial Organizations and includes many unions in the steel, rubber, automobile, petroleum, textile, and other great mass-production industries. Mr. Lewis and his associates have been charged by President William Green, of the American Federation of Labor, with attempting to set up a rival organization composed of industrial unions; and the A. F. of L. unions which allied themselves with the C.I.O. have been expelled from the Federation.

The outcome of this struggle is a thing of the future. In losing the unions that formerly belonged to the A. F. of L. but are now gathered under Mr. Lewis's banner, the Federation lost about one-third of its membership. However, through active organization in the past few years, it has secured more than enough new members to make up for those that it lost. We cannot undertake here to discuss in detail the relative merits of craft and industrial unionism. It is clear, however, that the increasing mechanization of the twentieth century has made craft skill far less important

than it was in the early days of the American Federation of Labor. Hence, if there is to be a strong labor movement in this country, it must include semi-skilled and unskilled as well as skilled workers. And it appears likely to have to proceed largely along the lines of industrial unionism, for only thus can it hope to muster the strength that is required for effective collective bargaining.

Prospects of Industrial Peace

Our discussion of employer attitudes toward unionism must not be allowed to give the impression that all American business men are opposed to collective bargaining. There are many, indeed, who would far rather deal with a strong union than with the workers individually; and there are certain socially minded employers who for years have been earnestly seeking a remedy for industrial conflict. Though conflict seems to be inherent in our type of economic system, means have been found for alleviating the situation to some extent.

Mediation and Arbitration.—It is possible, at times, to avoid open breaks between employers and employees through the use of mediation or arbitration. Mediation is a device for smoothing out the process of collective bargaining. The mediator is a disinterested third party, who meets with the disputants and attempts to bring them to satisfactory terms. He isolates the main issues from the non-essentials, and by creating an atmosphere of confidence aids the contending parties to reach an agreement, though he does not himself render a decision. When arbitration is resorted to, the parties to the dispute are given a hearing by the arbitrator (or board of arbitrators). In many instances, the disputants agree beforehand to accept whatever decision is rendered, but in some cases it is agreed that the parties concerned shall be free to accept or reject the award.

The National Labor Relations Act, to which we have referred several times in the present chapter, provides for arbitration under the supervision of the National Labor Relations Board. Submission of disputes to this Board is voluntary; but once the disputants have agreed to accept the services of the Board, whatever award the Board makes is final and enforceable by the courts. The success of the Board in settling disputes, during the first two and one-half years of its operation, has been outstanding. Of the cases that came before it in that period, 16 per cent were dismissed, 24 per cent withdrawn, and 55 per cent, which affected one and a

quarter million workers, were settled amicably by agreement. Hence, only 5 per cent reached the stage of formal hearing, and in only 2 per cent did the Board issue "cease and desist" orders against employers. Three-fourths of the strike cases that came to the Board were settled.

Mediation and arbitration are valuable in providing a period of calm deliberation before a strike or lockout is declared. However, the agreement reached is more likely to reflect the bargaining power of the two parties than to be based on any principles of "justice" or "fairness." An arbitrator, trying to please both contestants, usually comes to a decision that represents a compromise, giving to each party somewhat less in the way of advantage than has been asked for. Thus a truce is patched up and weapons are laid aside temporarily, but the conflict is fairly certain to be resumed whenever a shift in bargaining strength gives promise to one or other of the parties that gains may be realized through a display or exercise of power. However, despite the temporary nature of most settlements, arbitration serves a useful purpose in reducing the number of disputes that reach the strike stage. It is less costly than recourse to militant measures, and is therefore preferable to the strike as a means of effecting the economic readjustments that must be made from time to time.

The Outlawry of Strikes.—The question of whether workers should ever be allowed to go on strike is sometimes raised. The strike often brings inconvenience and hardship to employers, employees, and the public. Like military warfare, it does not decide the right or wrong of an issue, but merely determines which side, for the moment, is the stronger. Hence the strike, like the lockout, is socially objectionable. Nevertheless, "a strike may be less harmful to the state and to industry than peace maintained either by statutory tyranny, legal usurpation, or overwhelming economic domination."[10] To outlaw the strike would mean to destroy the workers' bargaining power, since, in the last analysis, this power rests upon the ability to damage the employer's business interests by waging a strike.

The prohibition of strikes might be justified in the so-called "essential industries," which must be operated continuously if the public welfare is to be preserved. It would seem best, in the case of such industries, to take them entirely out of the field of private

[10] Solomon Blum, *Labor Economics*, New York, Henry Holt & Company, Inc., 1925, p. 268.

enterprise, and to serve notice that in these particular industries strikes will not be tolerated. So long as an industry is in the hands of private enterprisers, being operated for the profit of its owners, it would be obviously unfair to hamper labor in its profit-seeking activities by abolishing the right to strike in that industry. A further problem that would have to be solved is that of determining which industries were to be regarded as essential. Probably most persons would agree that the mining of coal and the operation of communication and transportation lines are vital to the welfare of the public. But may not the production and distribution of milk, bread, and other forms of foodstuff be equally essential? Indeed, a move to abolish industrial strikes on the basis outlined above might easily lead to the public ownership of many types of industry.

Peace Through Conference.—Employee representation, as we have already noted, has for its outstanding feature a system of frequent conferences between chosen representatives of the employer and his employees. It "aims to provide government by consent of the governed. It is built upon the assumption that free discussion between management and workers will bring about a better understanding of the problems to be solved, create a spirit of genuine cooperation, call forth helpful suggestions from intelligent workers, and permit the settlement of differences by negotiation instead of combat."[11] There are few who would challenge the assertion that industrial peace can be promoted through friendly conferences which keep the employer and employee informed of each other's problems and aspirations. There are many who question that the conference plan can be wholly successful in this respect, so long as it is based upon the company union, which so many workers regard with suspicion.

But this particular handicap to employer-employee conferences can be avoided through the adoption of what is popularly known as "union-management cooperation."[12] Under this plan of organization the workers belong to independent unions, not company unions, and consequently have behind them the power of collective bargaining that goes with effective unionization. Thus, they are not dependent upon the benevolence of the employer, but are able to fight their own battles in the writing and enforcement of a trade agreement. But union-management cooperation provides also for

[11] Paul F. Gemmill, *Present-Day Labor Relations*, p. 58.
[12] *Ibid.*, chap. 9.

frequent meetings between the representatives of management and workers *in a given plant*, and these meetings have proved extremely helpful in the solution of local problems. The signal success which has attended the operation of union-management cooperation in the case of the Baltimore and Ohio Railroad has led to its installation in other establishments in this country and Canada.

Conclusion.—In a society which endorses free enterprise and competition, and measures success by the individual's ability to acquire material wealth, it is difficult to see how industrial conflict can be eliminated, since every incentive is in the direction of getting for one's self all that one can. "It is an indisputable fact," wrote the late Ramsay MacDonald, "that the wage earner and the wage payer have interests which are antagonistic, and in the nature of things cannot be reconciled."[13]

It appears that the most that can be done, under existing conditions, is to make the best of a bad situation. If industrial conflict cannot be avoided in a competitive economic order, we can at least provide "an open field and a fair fight," and seek, at the same time, to safeguard the interests of the public. There can be no "fair fight" without the development of a unionism strong enough to win the respect of employers and to enforce collective bargaining. The absence of such a degree of strength means economic serfdom. To maintain a strong bargaining position involves adherence to the principle of the closed shop, but the closed union should be opposed. Arbitration is preferable to the strike, even though the former ends in a compromise and its decisions hold good only until a new agreement is drawn up. But it seems reasonable that the strike should be forbidden only in those industries that are sufficiently essential to the public welfare as to justify their socialization.

It is entirely possible that there would be no problem of industrial conflict in a socialist or communist state. But to many Americans a cure of this kind would doubtless appear to be worse than the disease itself.

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1. It is held by some that the interests of employer and employee are identical, and by others that these interests are antagonistic. What is the truth in the matter?
2. Speaking not as an employer or employee, but as a member of

[13] J. Ramsay MacDonald, *Socialism and Society*, London, Independent Labour Party, 1905, p. 113.

society, state your reasons for favoring or opposing collective bargaining.

3. Compare the number of American workers under "employee representation" with the number belonging to unions that are independent of employer control.
4. Explain why labor organizations regard "recognition of the union" as vitally important to their interests.
5. Trade unionists insist upon applying the principle of "standardization" to wages, hours, and working conditions, in drawing up their trade agreements. Why do they regard this principle as important?
6. "It is the open union operating under the closed shop principle that most students of labor regard as the best form of labor organization that has yet been devised." In what respects is this combination superior to (a) the open union and open shop, and (b) the closed union and closed shop?
7. The strike and the lockout are said to be "similar in purpose, in method, and in social consequences." Examine this statement critically.
8. What are the purposes and the methods of sabotage?
9. In what respect does the closed union resemble the industrial monopoly?
10. Explain the way in which a successful union tends to get for its members the favorable wages, hours, and working conditions which "would tend to come to these workers *in the long run* and *under competitive conditions* even in the absence of a union organization."
11. Discuss the methods of limiting output which are sometimes practiced by organized workers.
12. Cite instances in which enterprisers also are guilty of restricting production.
13. Why are unionists so violently opposed to "yellow-dog" contracts and to the use of judicial injunctions in labor disputes? What threat do such contracts and injunctions hold for the future of unionism?
14. If industrial strikes were outlawed, the public would be saved a great deal of inconvenience and even hardship. Why, then, should we hesitate to prohibit the use of the strike?
15. On what basis has the closed shop been attacked by those who have conducted the "open shop movement"?
16. Describe the essential features of the company union.
17. Trade unionists who are antagonistic to "employee representation" are very kindly disposed toward "union-management co-operation." Why?

18. Discuss "Section 7a" of the National Industrial Recovery Act, and the National Labor Relations Act. How would you expect legislation of this kind to affect (1) independent and (2) company unionism?
19. What are the relative merits of "craft" and "industrial" unionism under present-day economic conditions?
20. "The class conflict between an owning and a working group is not only a logical thing to expect but a fact which has unquestionably been found in history," says Norman Thomas (*America's Way Out,* New York, The Macmillan Company, 1931, p. 138). Is there, then, any solution of the problem of industrial conflict?

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3 ECONOMIC INSECURITY: UNEMPLOYMENT

ONE OF THE DISTINCTIVE FEATURES OF MODERN ECONOMIC LIFE IS THE SEPARATION OF THE WORKER FROM OWNERSHIP OF THE tools with which he performs his daily tasks. Business is owned and controlled by corporations, partnerships, and individual enterprisers. Economic society is made up largely of employers and employees—those who provide jobs and those who fill them.

The Worker and His Job

The importance of a job to the worker of today can scarcely be exaggerated. "Any one who has associated with those dependent upon daily toil for their living knows the positive terror in which thousands of men live as they think of the possible loss of their opportunities to work,"[1] says one writer. Mr. Whiting Williams, who, in his studies of the workingman, has donned overalls and worked side by side with laborers in many industries, believes that "this insecurity of the job causes more antipathy to the whole industrial, social, economic, moral, and political structure than all other things put together."[2] And Mr. Herbert Hoover, long before he became President, stated that "no waste is greater than unemployment, no suffering is keener or more fraught with despair than that due to inability to get jobs by those who wish to work."[3]

The Significance of a Job.—This emphasis upon the importance of an opportunity to work is fully justified by the situation. Among the minimum requirements of human beings are food, clothing, and shelter. Only in very primitive communities are all of these commodities made directly by those who consume them. What happens nowadays is that workers engage in highly specialized occupations, and in return for their contribution to pro-

[1] Francis J. McConnell, in Kirby Page, editor, *A New Economic Order,* New York, Harcourt, Brace & Company, Inc., 1930, p. 348.

[2] *Annals of the American Academy of Political and Social Science,* March, 1931, p. 3.

[3] Quoted by Edward Eyre Hunt, in *Survey Graphic,* April, 1929, p. 6.

duction they receive purchasing power, usually in the form of money wages, with which they buy the commodities and services that they want most. But the dangers of the system are apparent. For human needs and human wants continue as long as life itself, but the ability of the worker to satisfy these needs and wants depends upon having a job. Hence, the loss of a job may spell tragedy. No job, no wage; no wage, no purchasing power; no purchasing power, no economic goods, is the inexorable sequence of negatives that causes workers to dread the day of unemployment.

The misery is multiplied, of course, when the loss of work falls upon the man who has a wife and children to support. Even a short period of unemployment frequently means a lowering of standards of living, and often to terribly low levels. Whatever savings may have been laid aside have to be managed with great economy. Reductions in expenditures are made all along the line. The food supply declines in both quantity and quality. The two or three quarts of milk are reduced to one, and such luxuries as fruits and fresh vegetables disappear from the menu. Often the parents deny themselves food that they need badly, so that the children may not suffer from hunger. In the consumption of clothing and shelter, also, sacrifices are necessary. The children may have to go to school insufficiently clad, even to the extent of wearing soleless shoes in cold weather. Probably the family moves to smaller and cheaper living quarters in a less desirable section of the city. Fuel, too costly to be wasted in heating the rooms, is in some instances used only for cooking the meager meals. These are only a few details of conditions following close upon the heels of unemployment, as reported by hundreds of social workers. Notwithstanding these economies, it usually takes many months for workers to get out of debt after business picks up again, and in some instances these obligations are never met. Studies of the effects of unemployment upon family life make gloomy reading.[4]

Unemployment: A Phase of Economic Insecurity.—Unemployment is commonly defined as involuntary idleness on the part of workers who are able and willing to engage in productive activities if given the chance to do so. Since, despite their desire

[4] True accounts of poverty resulting from unemployment that occurs even in the most prosperous of American "good times" may be found in Clinch Calkins, *Some Folks Won't Work*, New York, Harcourt, Brace & Company, Inc., 1930.

for work and their attempts to find jobs, these would-be workers are unable to secure employment, their incomes are cut off, and they and their dependents suffer from the lack of commodities and services that are essential to their well-being. In our highly complicated economic society, the worker's ability to secure an income depends not only upon his skill and willingness to accept employment, but upon any of a host of conditions over which he as an individual has little or no control. He may be so lucky as to have steady work year in and year out, or, on the other hand, he may find himself dispossessed of his job and a victim of temporary or permanent unemployment. The economic maladjustments that result in enforced idleness, and consequent loss of income, constitute the problem of unemployment, which, in turn, is the most serious phase of the broader problem of economic insecurity.

The Extent of Unemployment

The Post-1929 Depression.—The seriousness of the problem of unemployment in the United States cannot be stated in any very satisfactory terms. There have been some attempts to gather together figures showing the number of persons out of work, but the machinery available for the collection of data is woefully inadequate. No government census of unemployment was taken in this country between 1910 and 1930. The census of 1930 was the outcome of a popular demand for unemployment statistics for the period of business depression that followed the stock market crash of 1929. This census showed, according to the Secretary of Commerce, that there were 6,050,000 jobless workers in the United States in January, 1931, and that an additional 250,000 to 300,000 workers were idle "because of lay-off from their regular jobs at the time of the special census."[5] Just how many workers were still holding their jobs only on "part time" does not appear in the report, but Dr. Charles E. Persons, formerly of the Census Bureau and a recognized expert on unemployment, says on this point: "The conclusion that the number on part time in industrial centers may be expected to about equal the number completely idle, is perhaps as well justified as any statement regarding unemployment can be at present. The number of part-time workers rises to higher levels in times of depression in sections where employers are imbued with the modern philosophy of spread-

[5] *American Labor Year Book, 1931,* New York, Rand School Press, 1931, p. 31.

ing the available employment over the entire work force."[6] It seems likely, then, that even in the early years of the post-1929 depression as many as ten or twelve million workers were wholly or partly unemployed; and the number of involuntarily idle probably reached sixteen millions when the depression was at its worst. However, it must be remembered that these figures are estimates, and may not be wholly accurate. But they are the best we have, and they do give some notion of the extent to which incomes, and consequently standards of living, may be affected by interference with business operations.

Unemployment in "Good" and "Normal" Years.—In the early days of the depression, the Director of the Census estimated that we had in the United States between 47,000,000 and 49,000,000 "gainful workers."[7] This did not mean that that number actually had jobs, but that these men, women and children were able and willing to work, and therefore were members of the labor force of the country. If we place the number at 48,000,000, and accept the figure of 16,000,000 unemployed in 1933, it is evident that about one-third of the nation's workers were deprived of the means of livelihood in that year.

However, the raids on income made by unemployment are not confined to years of depression. To be sure, they are most spectacular in such periods; but in times of "prosperity," also, there is a surprisingly large amount of involuntary idleness. It seems that unemployment, like the poor, we have always with us. Indeed, there is doubtless a causal relationship here, for certainly some, though by no means all, of our poverty is directly chargeable to the persistence of unemployment. A committee of engineers, appointed by Mr. Hoover to study industrial waste in 1921, reported that unemployment is ever present. "In the best years," ran the report, "even the phenomenal years of 1917 and 1918 at the climax of wartime industrial activities, when plants were working to capacity and when unemployment reached its lowest point in twenty years, there was a margin of unemployment amounting to more than a million men. This margin is fairly permanent; seemingly one or more wage earners out of every forty are always out of work."[8] The Russell Sage Foundation also sets the minimum

[6] *Annals of the American Academy of Political and Social Science*, March, 1931, p. 15.

[7] *New York Times*, September 1, 1930, p. 15

[8] *Waste in Industry*, Report of Federated American Engineering Societies, New York, McGraw-Hill Book Company, Inc, 1921, p. 15.

of jobless workers at 1,000,000 in the years of greatest productive activity; while the National Bureau of Economic Research estimates that in the seven-year period from 1920 to 1927, inclusive, the year of *least* unemployment was 1920, with 1,401,000 workers unsuccessfully seeking jobs. Finally, we may give the estimate of Professor Paul H. Douglas, who calculates that over a thirty-year period the *average* amount of unemployment for all industries in the United States has been approximately 8 per cent.[9]

Types of Unemployment.—The average worker hunting a job probably does not know that there are several kinds of unemployment, and would not be interested in the fact if it were brought to his attention. To him the all-important question is how to find employment so that he may again enjoy an income. But to the student of labor problems, searching for a remedy for unemployment, an understanding of the types of unemployment and their causes is of first importance. We shall examine, in turn, "cyclical," "seasonal," and "technological" unemployment.

Cyclical Unemployment

The Business Cycle and Unemployment.—The term "cyclical unemployment" is derived from the business cycle, with which unemployment of this type is associated. The words "business cycle" are simply a convenient expression for designating the wave-like fluctuations in business activity which most writers on economics describe as consisting of four phases—*prosperity, crisis, depression,* and *recovery*—and which are dealt with at some length in Chapter 10. Employment is plentiful in times of prosperity, it declines with the appearance of a crisis, it is scarce during the depression, but increases in volume with the recovery of business. The particularly serious stage of cyclical unemployment, then, is the period of business depression. A survey of business conditions in the past reveals the fact that many of these periods of depression, which are commonly referred to as "hard times," have been experienced by all of the highly industrialized countries, for the business depression is no respecter of nations—it smites industry throughout the world, though some countries fare less badly than others. Since the period of depression is a time of very limited production, business concerns reduce their operations or shut down their plants completely, many workers are laid off or forced to go

[9] Paul H. Douglas and Aaron Director, *The Problem of Unemployment,* New York, The Macmillan Company, 1931, p. 32.

on part time, and privation and suffering follow as a matter of course.

The Severity of Cyclical Unemployment.—Business depressions vary in their intensity, and it is customary to distinguish between "major" and "minor" depressions. Since the turn of the century we have had, in the United States, four major and three minor depressions, the major depressions falling in 1907-08, 1914-15, 1920-21, and 1929-38, and those of lesser importance in 1911, 1924, and 1927. Naturally, the greater the intensity of the depression, the larger the resultant army of unemployed. Professor Douglas has made some interesting estimates of unemployment in manufacturing, transportation, the building trades, and mining, which show that in these industries 16 per cent of the workers were unemployed in 1908, 9 per cent in 1911, 16.4 per cent in 1914, 23.1 per cent in 1921, and 12 per cent in 1924.[10] The greater severity of unemployment in the major depression years of 1908, 1914, and 1921 is evident. Not only is unemployment more serious in some years than in others, but workers in certain occupations are particularly liable to be released from their jobs in time of depression. For example, Professor Douglas found that in 1914, 32.2 per cent of the workers in coal mining and 34.6 per cent in the building trades were deprived of their jobs, whereas in manufacturing and transportation the percentage was only 12.9.

The extent of cyclical unemployment in our great industrial centers may be illustrated by the case of Philadelphia. A study conducted by the Works Progress Administration showed that in 1933, the worst year of the post-1929 depression, only 34.1 per cent of Philadelphia's "employable persons" had full-time work, 19.9 per cent were on part time, and 46 per cent were wholly unemployed. Comparable figures for 1937 were 70.5, 5.0, and 24 5 per cent, respectively, for the three categories of employment status given above.[11]

The seriousness of cyclical unemployment lies not only in the number of workers thrown out of employment, but also in the length of time that they are compelled to go without work. Periods of depression last from a few months, in the case of minor disturbances, to as long as several years when the business disruptions

[10] *Ibid.*, pp. 28, 29. Professor Douglas does not give the data for 1927 or for the post-1929 depression.

[11] *Recent Trends in Employment and Unemployment in Philadelphia*, Philadelphia, Works Progress Administration, December, 1937, p. 46.

are of greater proportions. The National Bureau of Economic Research estimates that the "downward swing" of the business cycle (including crisis and depression, both of which bring unemployment) has an *average* duration of some sixteen or seventeen months. Since the downward swing is often much shorter than this, it must of necessity be considerably longer at times. The point is important in connection with unemployment only in its suggestion that unfortunate workers may, through cyclical unemployment, be out of work not only for months but even for several years. Indeed, the post-1929 depression brought enforced idleness to some workers for as long a period as five or six years.

Short and Long Depressions.—Perhaps a deep depression of short duration would cause less harm to workingmen and their families than a long-drawn-out period with a smaller percentage of workers unemployed. The former would throw many out of work for a short time, but the latter, through long-continued idleness for a smaller number, virtually overwhelms with misery those whom fate has chosen as victims. But industrial workers, like beggars, cannot be choosers. In their impotence to influence the business cycle they must take business depressions as they come. And it so happens that the depressions that cut deep, severing men by the millions from their jobs, are also those that seem to stretch out interminably, leaving behind them malnutrition, sickness, and discouragement for those least able to bear these ills, and a consequent resentment toward the existing economic and political order.

Seasonal Unemployment

It is cyclical unemployment, with its millions pleading for jobs, with soup kitchens and bread lines and frantic appeals for relief funds, that most persons think of when the word "unemployment" is mentioned. But seasonal unemployment, though it commands less attention in the public press and is the subject of fewer discussions in the conventions of learned societies, is probably responsible for at least as much involuntary idleness as cyclical unemployment. The reason is that seasonal unemployment adds to its tally year in and year out, and not only in periods of business depression.

Production and Unemployment.—Steady employment is dependent, of course, upon the continuous operation of business

establishments. If production is interfered with, even for a short period, some employees will be laid off or put on part time. Since seasonal unemployment goes hand in hand with declines in production, an examination of seasonal fluctuations in production gives a clue to the state of employment. If steady employment is closely related to continuous production, then any wide variations in production that take place in a period so short as to exclude an appreciable change in the quantity of labor available, are strongly suggestive of seasonal unemployment. For if the number of workers in an industry is sufficiently large to run the industry when production is at its height, it would seem to follow that some of these employees must be jobless whenever production falls off—unless, as is most unlikely, they can readily find temporary jobs in other branches of industry.

Automobile Manufacture: A Seasonal Industry.—An example from the automobile industry will serve to illustrate the point. If the production of automobiles were spread out evenly over the year, it might be expected that the output for each month would constitute about 8 1/3 per cent of the total annual production. But Table 1, which is based on average monthly percentage figures for the years 1922 to 1928, inclusive, shows that the production of automobiles is far from uniform. March, April,

TABLE 1.—PERCENTAGE OF ANNUAL OUTPUT OF AUTOMOBILES PRODUCED EACH MONTH[a] (1922 to 1928, inclusive)

Month	Per Cent	Month	Per Cent
January	6.3	July	8.6
February	7.8	August	8.9
March	9.6	September	8.3
April	10.2	October	8.5
May	10.1	November	6.6
June	9.2	December	5.9

[a] Source: National Automobile Chamber of Commerce. Quoted in Edwin S. Smith, *Reducing Seasonal Unemployment*, New York, McGraw-Hill Book Company, Inc., 1931, p 259.

and May are clearly the months of "peak" production, while November, December, and January are "valley" months, with production at its lowest. If, now, we assume that the 350,000 to 400,000 automobile workers of the United States were fully employed in April, when production was at its maximum, we must conclude that in the minimum month of December many thou-

sands of these workers were involuntarily idle, for production in December was only about three-fifths as great as in April.

Clothing, Building, and Mining.—Other industries that are notoriously seasonal in nature are the clothing and building trades and the mining of bituminous coal. "As Impartial Chairman in the Men's Clothing Industry in the City of New York during the past eight years," says Dr. Jacob Billikopf, "I have found that the men and women in the clothing industry, especially in the metropolis, have not averaged more than thirty-two weeks' employment in any year in the past decade, with the exception of the cutters, who constitute the most skilled element in the industry. The situation has been even more acute in the ladies' garment industry, about eighty per cent of which is located in and around New York City. In 1927, a highly prosperous year [in the clothing business, though one of mild depression for industry in general], the International Ladies' Garment Workers of America conducted a strike which lasted several months. One of the essential demands of the workers was a guarantee of thirty or thirty-two weeks' employment a year, which was denied."[12] About 350,000 workers are engaged in making men's and women's clothing in this country. The manufacture of women's clothing is especially seasonal, with peaks in March and October, and valleys in January and July. In 1929, for example, only five-eighths as many workers were busy in July as in March and October in the women's clothing industry.

Employment conditions in building construction and bituminous coal mining also are very bad. A committee on seasonal operation in the construction industries, appointed by Mr. Hoover when he was Secretary of Commerce, reported that it is "the general rule that the building trades are occupied wholly for only three to five months in the year." Other investigations have shown that in many branches of the building trades the workers are employed only about 80 per cent of the year.[13] The situation is particularly serious because there are about a million and a half workers in the building trades who, as the result of the seasonal nature of the industry, find 50 per cent less employment in the poorest winter month than during the height of building activity in the summer. The production of bituminous coal is largest in November and smallest in

[12] *Annals of the American Academy of Political and Social Science*, March, 1931, p. 65.

[13] Edwin S. Smith, *Reducing Seasonal Unemployment*, p. 285.

April, with the output in the minimum month about three-fourths as great as that of the maximum.

Are All Industries Seasonal?—We have cited several industries in which the seasonal fluctuations are very large. Though these are not typical examples, they are of particular significance because of the extent of the variations in production and the large number of workers affected in the months of slight business activity. But there is reason to believe that, on a smaller scale, practically all industries are seasonal. "It would be most difficult to find an industry which showed an even distribution of production and employment throughout the year," says Dr. Isador Lubin, an expert on labor problems. "An individual plant here and there, to be sure, may show steady and regular employment from month to month, but such plants are exceptions and by no means the rule in any industry. Some industries, like some plants, show less fluctuation in employment than others, but none are free from seasonal ups and downs."

Data compiled by the Research Division of the Federal Reserve System indicate that in the field of *manfacturing as a whole* there is a peak of activity in mid-September, in which 4 per cent more workers are employed than at the low point of activity in mid-January. Professor Douglas figures that seasonal fluctuations in manufacturing, transportation, the building trades, and mining, cause on the average about 6 per cent of the workers in these industries to be unemployed.[14] If other occupations (such as public utilities, merchandising, domestic and professional service, and government employment) were included, the estimate would have to come down somewhat, dropping perhaps as low as to 5 per cent. It is probably not far from correct, then, to say that on the average one-twentieth of our American workers are always out of work by reason of seasonal unemployment.

Technological Unemployment

The Problem of Permanent Lay-offs.—A third type of enforced idleness, to which Professor Sumner H. Slichter gave the name "technological unemployment," has been receiving a great deal of attention of recent years. The term is not wholly satisfactory, because, as Professor Slichter himself points out, it suggests only displacement by mechanical changes in industry, whereas the problem is in reality a much broader one—"the problem of

[14] Paul H. Douglas and Aaron Director, *The Problem of Unemployment*, p. 84.

unemployment produced by permanent lay-offs."[15] A *permanent lay-off* does not necessarily mean *permanent unemployment*, but it does mean that the concern for which a man has worked has no further use for him, at least not in his former capacity. Among the most important causes of permanent lay-offs are improved technical processes, the extension of scientific management, the increasing popularity of industrial mergers, and important changes in demand on the part of the consuming public.

Labor-saving Machinery.—In dealing with industrial conflict, we referred to labor's tendency to fight the introduction of labor-saving devices, owing to the fear that the new machinery would bring unemployment in the form of permanent lay-offs. Despite this opposition, new processes are being brought into industry continually, and it is probable that there have been more revolutionary changes in manufacturing technology during the past two decades than in any equal period of time in history. One of these changes was the introduction of the automatic loom into textile manufacture, with the result that one worker can now take care of 24 to 64 looms, as compared with the one to eight looms previously handled. A second innovation is the cigarmaking machine, which manufactures from 3000 to 4000 cigars in an eight-hour day, and threw out of employment over 30,000 skilled cigar-makers, each capable of producing only 300 cigars a day. Yet another technical improvement is the use of the "continuous process" in the manufacture of plate glass, which now turns the glass out in a continuous ribbon instead of in small cylinders which had to be cut and flattened. The new process means a reduction of 40 per cent in the amount of labor required.

These are examples of the mechanical changes that have taken place in scores of manufacturing industries which, according to Federal Reserve data, increased the *output per man* some 45 per cent between 1919 and 1929, and turned loose from their jobs some 500,000 workers, or about 6 per cent of the total number formerly engaged in manufacturing.[16] A similar movement has

[15] Sumner H. Slichter, "The Problem of Technological Unemployment," in *Unemployment and Adult Education (A Symposium)*, New York, American Association for Adult Education, Inc., 1931, p. 34.

[16] The Research Department of the International Brotherhood of Electrical Workers has compiled a list of forty-six important automatic machines that have done much to eliminate human labor from certain branches of industry. See *Annals of the American Academy of Political and Social Science*, March, 1931, pp. 19, 20.

been going on in agriculture. The use of the most improved farm machinery, such as tractors and combines, brought an increase in agricultural product of 25 per cent *per worker* in this ten-year period. Though we are raising more farm products than ever before, we are doing it with fewer workers. Our farm population has declined by 4,000,000 persons in the past decade and a half, which probably means that a million or a million and a half farm laborers, with their families, have been forced by technological unemployment to seek their fortunes in the city.

The railroads, though handling more freight now than ever before, have laid off about 1,000,000 workers since 1919. Switchmen and brakemen have been displaced by a mechanism for shifting and sorting cars, and 17,000 railway firemen were released by western railroads through the installation of mechanical firing apparatus. Another great basic industry, coal mining, has also felt the pressure of mechanical progress. Seventy-one per cent of the bituminous coal produced in the United States is now mined by machinery—a fact which helps to explain why 200,000 miners lost their jobs during the past fifteen years.

Improved Methods of Management.—Some technological changes take place suddenly, rendering useless almost overnight the acquired skill that trained workers have built up over a long period of years. But permanent lay-offs may also be produced by "small, non-revolutionary technical changes, by small improvements in management, by the gradual tightening of efficiency."[17] Scientific management, for example, is ever on the lookout for better methods of procedure, which in some cases make it possible to turn out the same amount, or even a larger amount, of product with fewer workers. Time and motion studies, which are devices of scientific management, tend ordinarily to split jobs into smaller and simpler parts. Some of these smaller operations are distinctly repetitive, and can be intrusted to the speedy, certain performance of machinery. Others are so simple as to require little or no skill on the part of the workers. A case in point is modern automobile manufacture, in which, according to Mr. Ford, 43 per cent of the jobs can be learned in one day, and 36 per cent in one day to a week. The adoption of scientific methods may result, then, in the displacement of men by machines, and of highly skilled workers by those who can perform the tasks put to them with almost no

[17] *Ibid.*, p. 34.

training. In these and other ways, scientific management is in part responsible for technological unemployment.

Mergers and Unemployment.—Business mergers or consolidations, which were once viewed with suspicion and apprehension in this country, take place so often nowadays that they no longer excite comment.[18] They, too, have helped to raise the total of technological unemployment, by laying off employees who, by reason of the new arrangements, have been rendered superfluous. Many writers have called attention to the excessive productive capacity of most of our industries. One-sixth of our 1129 boot and shoe factories, if operated on full time, could produce our present output of footwear. The total present output of cement and bituminous coal in this country could be produced by three-fifths of our cement mills and one-fourth of our coal mines.[19] In some lines of industry this overexpansion of plant is now in process of being eliminated through consolidations which will close down the less efficient units and thus effect large economies.

This elimination of waste in industry is highly desirable, from the point of view of both enterpriser and society in general, but it does add to the burden of technological unemployment. At the same time, however, it lessens somewhat the amount of seasonal unemployment. Mr. Sam A. Lewisohn says that "unemployment may be due to bad management which creates seasonal unemployment or good management which causes technological unemployment." Excessive productive capacity is wasteful, is the result of bad management, and brings seasonal unemployment. When mergers eliminate this waste they benefit society at large through the exercise of good management, but at the same time often increase the quantity of technological unemployment. Mergers may cause the displacement of factory workers, office employees, salesmen, and other types of labor. It is stated that the merger of the Colgate-Palmolive-Peet Company caused thousands of salesmen and office workers to lose their jobs.[20] Even highly paid executives may be affected. "Never before were so many salaried men looking for positions," said *Forbes Magazine* a few years

[18] From 1922 to 1928 there were 201 mergers effected, involving 1259 business concerns. See Stuart Chase, "The Iron Bouncer," in *Unemployment and Adult Education (A Symposium)*, p. 14.

[19] These examples were cited by Ethelbert Stewart, former United States Commissioner of Labor Statistics, in *Annals of the American Academy of Political and Social Science*, March, 1931, p. 9.

[20] *Ibid.*, p. 23.

ago. "Men formerly receiving $10,000 to $30,000 are now anxious to start at half salary. Thus many bargains in human material are available."

The Effects of Permanent Shifts in Demand.—Permanent lay-offs are sometimes the result of permanent changes in demand. If the public refuses to buy a commodity, there is obviously no point in making it, and employers engaged in its manufacture are compelled to close down their plants. A striking example is the ship- and boat-building industry, which suffered a serious loss in demand following the World War and as a consequence laid off some 337,000 men. Social customs and fashions bring about changes that are often the despair of business men. Presumably because of the almost universal use of the automobile, the demand for shoes has fallen off to an extent that has alarmed the manufacturers. Short skirts decrease the demand for dress goods, but react favorably on the sale of silk hosiery. Bobbed hair destroys the market for hair nets, but provides an abundance of work for barbers. And so on. Professor Slichter believes that in at least twenty-three industries, a major reason, and perhaps *the* major reason, for the shrinkage in employment has been the contraction of markets.[21] Among the industries that have been injured in this way he lists shipbuilding, agricultural implements, the manufacture of carriages, wagons, horse blankets, fly nets, horseshoes, harnesses, whips, buttons, pins, needles, hooks and eyes, hair pins, combs, jewelry, cigar boxes, and sewing machines.

Finding a New Job.—We have spoken of unemployment of this kind as consisting of *permanent lay-offs*, and have noted the fact that the workers who are laid off are not necessarily slated for *permanent unemployment*. Many of them, after remaining idle for some weeks or months, find new occupations in other industries. Some, and particularly those who are well along in years, may never again find steady work. But in any case they are probably permanently cut loose from the type of work to which they have been accustomed, unless they should be successful in supplanting other workers doing similar work in other plants, in which case it will be these ousted workers who suffer from permanent displacement. The worker who is laid off because of cyclical or seasonal fluctuations is likely to find his job again available with the return of "good times" or the seasonal "peak."

[21] Sumner H. Slichter, "Recent Employment Movements," in *Survey Graphic*, April, 1929, p. 17.

But the victim of technological unemployment finds himself in a peculiarly tight place, from which he may be able to escape only by starting his working career all over again, with not only a new employer but a new occupation as well.

A Study of Job-hunting.—Several studies have been made with the thought of learning what becomes of the industrial worker who has been overtaken by technological unemployment. The most satisfactory of these for our present purpose is the investigation conducted by Dr. Isador Lubin and his associates, in which they followed the fortunes of 754 workers in more than twenty industries located in three different communities.[22] The group did not include any workers who had quit voluntarily, or any discharged for insubordination or inefficiency, but was made up wholly of "persons unemployed for causes over which they had no control," who had been laid off because of technological changes. There was a sufficient range in ages, occupations, and earnings to make the group fairly representative of industry as a whole.

The Amount of Time Lost.—Dr. Lubin found that of the 754 workers that had been discharged between September, 1927, and September, 1928, 344 (or 45.5 per cent) were still unemployed on the latter date. Of these 344 unsuccessful job-hunters, 63 (19 per cent) had been out of work for over nine months, 139 (41 per cent) for over six months, 221 (65 per cent) for over three months, and 258 (76 per cent) for over two months. Of the 410 members of the group who had found steady work by September, 1928, 294 (or 72 per cent) had been unemployed for more than two months, 228 (56 per cent) for more than three months, 95 (23 per cent) for more than six months, and 26 (6 per cent) for more than nine months. The permanency of technological lay-offs is indicated by the fact that fewer than 10 per cent of these men got their old jobs back. "Only 188 (45 per cent) of the workers who found employment had been able to secure jobs in any way similar to those formerly held. Two-thirds of the reemployed were found in what to them were new industries. Not only did they have to adjust themselves to a new environment but

[22] Isador Lubin, *The Absorption of the Unemployed by American Industry*, Washington, D. C., Brookings Institution, 1929. Other studies dealing with this phase of the unemployment problem are R. J. Myers, "Occupational Readjustment of Displaced Skilled Workmen," in *Journal of Political Economy*, August, 1929, pp. 473-489; and George E. Barnett, *Chapters on Machinery and Labor*, Cambridge, Harvard University Press, 1926, chap. 5.

also to a new type of product." These figures (which appear in tabular form in Table 2) support the contention that technological

TABLE 2.—TIME LOST BY 754 WORKERS WHO WERE DISCHARGED BETWEEN SEPTEMBER, 1927, AND SEPTEMBER, 1928

Those Who Had Found Jobs by September, 1928 (410)			Those Who Had Not Found Jobs by September, 1928 (344)		
Time Unemployed	Number	Per Cent of 410	Time Unemployed	Number	Per Cent of 344
Over 9 months	26	6	Over 9 months	63	19
" 6 "	95	23	" 6 "	139	41
" 3 "	228	56	" 3 "	221	65
" 2 "	294	72	" 2 "	258	76

unemployment often forces the displaced worker to make a complete readjustment of his industrial life.

The New *vs.* the Old Job.—It seems probable that in most instances the new job is not nearly so satisfactory as the old. Both mental and physical changes, and usually changes for the worse are wrought by technological unemployment. The worker's confidence in his economic capacity is shaken, for the craftsmanship in which he placed reliance has been scrapped by the march of technical progress. His savings are consumed as, week after week, he looks for work, and he may have to ask for aid from relatives or even from charitable organizations. When he finally succeeds in getting a new job, it is fairly likely to represent a sacrifice in both self-esteem and income. For if, though formerly a skilled machinist, boilermaker, or woodworker, he must now accept employment as counterman in a lunch-room, gasoline station attendant, or night watchman, he can scarcely help feeling that he has lost caste, while his pay envelope will often supply concrete evidence that society regards his present occupation as less important than the work from which he has been ousted.

On this last point, Dr. Lubin gives some interesting data having to do with the present earnings of his group of reemployed workers, as compared with their earnings in the last permanent jobs that they had held. For six per cent of these workers no information was available. For 19 per cent the changes had proved financially advantageous, for this percentage of the group were

earning larger incomes in the new jobs than in the old. For 27 per cent the amount of wages was virtually the same as before. But in about one-half of the cases (48 per cent, to be exact) the wages paid in the new jobs were definitely lower than those previously received. In most instances, the new jobs paid from 60 to 90 per cent as much as the old jobs, though in a few cases the earnings had dropped as much as 50 per cent. Translated into terms of human welfare, these wage decreases represent reductions in standards of living which were probably none too high in the first place.

The Absorption of Laid-off Workers.—This study of the job-finding experiences of displaced workers shows, among other things, that our economic system as a whole is able to absorb, to a large extent, the labor that is discarded by certain industries. New industries are continually springing up, and old ones gaining in importance. Automobile manufacture is almost wholly the growth of thirty-five years, and the commercial development of the radio has taken less than two decades. Thirty years ago the motion picture industry was a mere infant. Air conditioning is, of course, of still more recent origin. These newer lines of economic activity, and some of the older ones as well, have made great gains in the past decade or two, and not only have provided employment for a large part of the ever-increasing supply of labor, but also have given work to many men and women who have been displaced by mechanical inventions, scientific management, mergers, and changes in consumers' demands. Expansion in building construction between 1920 and 1927 drew 300,000 additional workers into the building trades, the increasing popularity of the automobile added some 700,000 new salesmen and garage workers, and the development of the hotel and restaurant business has given work to possibly a half-million men and women since 1920. A hundred thousand more men are selling life insurance, nearly that number of new operators have found employment in telephone exchanges, and probably as many as 250,000 additional teachers have been placed in our public schools.

United States census figures show that there was an increase of 7,218,341 in the number of "gainful workers" from 1920 to 1930. This does not mean, however, that there were seven million more persons *actually employed* in 1930 than in 1920, for the census officials include as "gainful workers" all "persons usually working at a gainful occupation," even though at the time of

census-taking they may actually be out of work. There can be no question of the expansion of established businesses and the rise of new industries providing employment for large numbers of persons. But we cannot judge from our labor statistics whether developments such as these are capable of taking care not only of the raw recruits of our industrial army, but also of that large group of experienced workers—estimated at between two and two and one-half millions in the period 1920-27—to whom economic changes bring permanent lay-offs. We shall again refer, later in the chapter, to the problem of placing workers who have been permanently laid off from their former occupations.

The Stabilization of Employment

The Inadequacy of Unemployment Data.—Our inquiry into the nature and extent of unemployment has been hindered by the absence of full and complete statistics of the present volume of unemployment and of changes in employment that have taken place throughout the country. When the data used have related to millions of workers, they have almost always been estimates and not exact reckonings; and when they have dealt with small numbers, we could not be certain that our "samples" were sufficiently large and diversified to be representative of the general situation. Nevertheless, the facts that are available indicate the tremendous seriousness of the problem of unemployment and the importance of finding a solution to it. To most students of the question it appears that one of the first moves toward a permanent solution must be in the direction of reducing the volume of unemployment through the stabilization of business.

Control of the Business Cycle.[23]—In the case of cyclical unemployment, the achievement of stabilization is quite beyond the power of the individual enterpriser. It is true that business men could, if only they would, do something to bring about more stable business conditions, by helping to prevent the "booms" of business activity which economists refer to as *periods of prosperity*. For, strange as it may seem, prosperity is the principal cause of depressions, and therefore of unemployment. In times of prosperity, with rising price levels, profits are large and business men wax expansive. "Manufacturers produce goods more rapidly than they are consumed. Merchants load their shelves with inventories. The increased demand for funds for business leads to

[23] The problem of the business cycle is dealt with in chap. 10.

increased interest rates, with the consequence that new enterprises, like the construction of new buildings, which are dependent upon an ample of supply of funds at low rates, are postponed. There thus ensues a period of reduced business activity and reduced employment."[24] If, then, business men in general could be induced to hold their business in check when scientific statistical data indicate that the danger point is being reached, it might be possible to avoid great heights of prosperity and depths of depression, and thus avoid cyclical unemployment. But, since business is conducted for immediate profits, it seems highly improbable that many enterprisers would be willing to make the temporary sacrifice; and an attempt to stabilize business in this way would be fruitless unless it were carried on by a large number of business men. Not only is a single enterpriser powerless to affect the general situation, but if he should check his business in time of prosperity, when others did not check theirs, he would himself suffer financial loss without appreciably delaying the coming of crisis and depression.

Private *vs.* Public Control.—The inherent weakness of private methods of controlling business cycles has led many persons to endorse the public control of the price level, in the belief that the stabilization of purchasing power would result also in the stabilization of business activity, substituting for our violent cyclical changes in business a slow, steady expansion of industry that would increase production only as fast as was necessary to meet the needs of growth in population and permanently rising standards of living. The soundness of this theory has not yet been tested in actual practice. It appears likely, however, that if business depressions and cyclical unemployment are to be eliminated, it must be through public, rather than private, control of credit, investments, or profits—or perhaps even through government ownership and control of business. So long as the profit motive remains uncurbed, it is hard to imagine an economic society free from business depressions, with their heavy toll of cyclical unemployment. The weighty problem of the public control of credit will be examined in Chapter 6.

The Reduction of Seasonal Fluctuations.—In the case of seasonal unemployment, on the other hand, individual attempts to control the situation give greater promise of success than public action. The ideal arrangement, from the point of view of

[24] W. Randolph Burgess, of the Federal Reserve Bank of New York, in *Survey Graphic,* April, 1929, p. 23.

steady employment, would be a spread of production evenly over the twelve months of the year. But there are forces that interfere with a neat system such as this. In some instances—as in the growing of grains and fruits, the manufacture of raw sugar, and the canning of mackerel and salmon—it is the conditions of *supply*, and particularly the perishability of the good, that determine when production shall take place. But much more often production takes its cue from the conditions of *demand*, and experiences seasonal fluctuations because consumers insist on having large quantities of some kinds of goods at certain times of the year and will buy only small quantities at other times.

One careful student of the subject concludes that "the causes of seasonal slumps are, for the most part, climatic; certain commodities enjoy a naturally good sale in cold weather, others in warm."[25] Style, which is not wholly unrelated to weather conditions, plays an important part in some industries, and notably in the manufacture of clothing. The sale of toys and fireworks is naturally greatest just before Christmas and the Fourth of July, respectively. The lure of the outdoors and the bad radio reception often experienced in summer cause the sales of radio receiving sets to be six or eight times as great in the fall as in the spring months. Tradition sometimes affects the seasonality of a business; building construction, for example, though now carried on successfully in the winter, is still a business which has by far its greatest volume in mild weather. In all of these instances, however, it is the factor of demand that causes the industries to be seasonal.

Examples of Seasonal Stabilization.—Since this is true in most instances of seasonal fluctuation, it is the consumers, rather than the producers, who are responsible for the resultant seasonal unemployment. Occasionally the ultimate consumer can be induced by price reductions to buy at "off seasons" of the year, as, for example, in the case of anthracite coal, the price of which is lowered in the spring in order to stimulate sales. But the buying habits of consumers are hard to change, and though some concerns have been able to stabilize sales by price concessions and by advertising the year-round merits of their products, these are obviously schemes that are limited in their applicability. It appears that most persons "want what they want when they want it," and refuse to be inveigled into buying at times suggested by the manufacturer or merchant.

[25] Edwin S. Smith, *Reducing Seasonal Unemployment*, p. 54.

It follows, then, that whatever is to be done in the way of lessening seasonal unemployment must be done chiefly by producers and not by consumers, even though it is the spasmodic buying of the latter that causes the trouble. Some manufacturers have virtually eliminated unemployment by establishing equal monthly production quotas, urging wholesalers to buy somewhat in advance of actual needs (sometimes offering the inducement of price reductions, or billing the goods only as used), and storing surplus stock in warehouses until it can be disposed of. The Packard Motor Car Company, Procter and Gamble, The National Cash Register Company, the International Harvester Company, and at least some dozens of other companies have used plans of this type successfully. The method would not be feasible, of course, with products that are very perishable or subject to sudden changes in style.

Another remedy that has possibilities of extension is the development of "side lines" that can be made during the slack seasons by the same working force as is used in the manufacture of the main product. The Beechnut Packing Company, which formerly packed only bacon, added peanut butter, chewing gum, crackers, and various kinds of canned goods to fit in with the highly seasonal packing of bacon. A concern manufacturing ice cream cones, which are consumed chiefly in summer, is now also making sugar wafers and candy bars, which find their greatest market in winter. The S. L. Allen Company supplements the manufacture of agricultural implements with the production of children's sleds at certain times of the year. The side line must be chosen, of course, with great care, for not only must it be something that the regular working staff can make, but it should also be a product that the regular sales force can sell. Otherwise, the whole purpose of the scheme will be defeated.

Some, though relatively few, concerns have adopted the so-called "flexible working week" for the purpose of reducing seasonal unemployment. The National Suit and Cloak Company, a large mail-order house with branches throughout the country, used to have very great seasonal fluctuations in their New York office. In remedying this situation, "they reduced their normal working week to about forty-four or forty-three hours. On this basis they established a flexible working week, so that in their peak periods they can work up to fifty-one hours and in their valley periods they can work thirty-nine hours; in other words, they distributed their load among their present people, without

reduction of wages."[26] Other firms that use the flexible working week in some form or other are the Delaware and Hudson Railway, Leeds and Northrup of Philadelphia, and the Columbia Conserve Company.

By-products of Stabilization.—These few illustrations give some idea of the efforts that are being made to lessen the volume of seasonal unemployment. It is fair to say, however, that thus far we have merely scratched the surface of this problem. The vast majority of employers have done little or nothing to stabilize production throughout the year. We may expect, however, to see an extension of the regularization of employment as business men come to realize that steady work for their employees is not only good ethics but good business as well. For the best workers tend to seek out those firms that provide regular employment through the year, and are even willing to accept *hourly* wages lower than the current rates, in order to enjoy a larger *annual* income. The assurance of steady work is also the proper antidote for "soldiering on the job," which is frequently practiced in order to avoid temporary lay-offs.

This does not mean that we shall soon witness the total disappearance of seasonal unemployment. In dealing with commodities that deteriorate in quality when stored, that are affected greatly by frequent changes in style, or that are so bulky that storage charges are practically prohibitive, the possibilities of manufacturing for stock are seriously restricted, and in many cases are eliminated altogether. Professor Douglas, who has given much thought to the matter, believes that even if manufacturers and merchants could be persuaded to do their utmost to reduce seasonal fluctuations, it is highly improbable that the total amount of seasonal unemployment could be cut by more than one-third.[27] This would be a great achievement, to be sure, but it would not solve the problem completely, for it would still leave (according to Professor Douglas's calculations) a residue of something like 4 per cent, on the average, of our American workers deprived of income by seasonal fluctuations in business activity.

The Handling of Technological Unemployment.—Any attempt that might be made to reduce technological unemployment

[26] Frances Perkins in *Annals of the American Academy of Political and Social Science,* March, 1931, p. 128.

[27] See *Annals of the American Academy of Political and Social Science,* March, 1931, p. 97.

raises at once the perplexing question of whether we should try to remove the causes of permanent lay-offs, for, as we have seen, these causes consist chiefly of improvements in mechanical and managerial technique or of changes in consumers' demand. It would scarcely seem desirable, from the social point of view, to interfere with the "good management which causes technological unemployment." Better methods of production mean a larger social income, and no nation is as yet so surfeited with goods that it can afford to spurn additions to its volume of commodities and services. It would appear unwise, also, to undertake to block permanent changes in demand, for these changes represent shifts in consumers' purchases made in the effort to maximize satisfactions. The decline of horse-drawn vehicles and the rise of the automobile constitute changes in demand that doubtless brought technological unemployment to carriage-builders, but the net gain to society in the way of better transportation facilities is beyond all question.

Technical Advance and the Volume of Employment.—It must be remembered, moreover, that technical progress does not necessarily lead to less work for the employees of the industry affected, or for workers in general. The improvements that are introduced may result in lowered costs and price reductions, bringing the commodity within the purchasing range of a much larger group of buyers and thus increasing greatly the quantity disposed of. This happy sequence of events would be possible, of course, only in the case of goods for which the demand is *elastic*—the total amount expended for the commodity increasing with a reduction in price. The automobile is a commodity of this type, and it is significant that, though tremendous technical advances have been made in the field of automobile manufacture, the normal number of workers in that industry is now greater than ever before. If, because of technical improvements, the price is lowered in the case of a good for which the demand is *inelastic*, less will be spent for that commodity than before, but the unspent remainder will be available for the purchase of other goods. In this event not all of the old employees could expect to retain their jobs; those displaced by the changed conditions of production would have to look for work in other fields of economic activity.

If monopoly control made it possible for the enterpriser to hold up the price of his product even though technical change had brought a great reduction in the costs of production, his larger

profits would be spent for either consumers' goods or capital, and would thus tend to "make work" in other industries for his displaced employees. The economists are correct, then, in their contention that the use of labor-saving devices or better methods of management do not *permanently* reduce the total volume of employment in society. But they may, and often do, throw men out of work *temporarily*, and with quite serious effects upon the individuals concerned. If the men laid off are the least desirable of the working staff (as is likely to be the case), if they are over rather than under forty-five years of age, and if (as usually happens) they refuse to believe that there is no chance of getting their old jobs back, the period of readjustment may cover many months, as Dr. Lubin's study has demonstrated.

Planning for Technological Changes.—But though there may be ample reason for insisting that industrial progress shall not be impeded, there is little justification for ignoring the plight of the workers whose loss through technological unemployment is coincident with society's gain. Many employers, as well as others, feel that it is the duty of economic society to lend aid to workers who must make occupational changes because their jobs have been wiped out by the adoption of better methods of production. One way to help is to plan ahead for the introduction of the new arrangement. The major discoveries in industrial technique do not ordinarily come into being overnight, but are developed gradually over a period of months or years. In every business there is a continual loss of employees, due to voluntary separations on the part of workers who think they see better opportunities elsewhere. It is often possible to take advantage of this fact, reducing the working force slowly by not hiring new employees to take the places of those who have resigned. By the time the new process goes into operation, the natural flow of labor from the plant has, in part at least, solved the problem of lay-offs. Moreover, the new device can often be introduced by degrees, as was shown by Fels and Company in the installation of soap-wrapping machines, each of which did the work of 250 women wrapping by hand. Two machines were needed to handle the firm's output, but the second machine was not put in until the staff of hand-wrappers had been depleted by death, marriage, or resignation—but not by discharge. It is doubtless true that industry cannot always be so considerate, but business enterprisers should be given to understand that there are certain obligations which they owe to their employees, and

that society will not excuse technological unemployment which might have been avoided through the exercise of foresight and advance planning.

Aid in Making Readjustments.—It is not too much to demand that business concerns, instead of casually turning workers loose to shift for themselves, shall first make a genuine effort to transfer them to other work in the same plant, and failing in this try to place them with other firms. Surely this much at least is due to men and women who have cast their lot with a business establishment and in many instances have given long years of unstinted service to their employers. The problem is too involved, however, to be solved by employers alone. There is need of vocational guidance for the young, so that they may be warned against going into those industries that are in process of shrinkage; need of employment exchanges to offer encouragement and advice in the case of those unavoidably laid off; and need of retraining for those unfortunate workers who, because of conditions over which they have no control, find their occupations gone beyond recall. There should be, then, the development *at public expense* of a definite plan for handling the many and difficult problems that the rush of technical progress is forcing upon us.

Public Employment Agencies

Cyclical, seasonal, and technological unemployment could all be lessened somewhat if provisions were made for placing the unemployed workers promptly in whatever jobs happen to be open. Even in periods of the greatest cyclical unemployment, there are some jobs that remain unfilled simply because the right men do not chance to apply for the openings. We have been remiss in not developing in the United States the machinery for putting unemployed workers in contact with unfilled jobs. As a consequence, many workers, who could be placed satisfactorily under a sound system of employment exchanges, now walk the streets looking despairingly for openings which are unattainable only because their existence is unknown to the jobless.

The Inadequacy of Private Employment Agencies.—The agencies that we now have for placing labor are far from adequate. There are, for example, some 3000 to 4000 private employment bureaus, but many of these are inefficiently or dishonestly operated. Some bureaus charge unreasonably high fees, raise their fees in times of greatest scarcity of jobs, split fees with the foremen who

hire their applicants, and indulge in other highly objectionable practices. There are properly conducted private agencies, of course; but so flagrant have been the abuses and so inefficient the services rendered that fee-taking private agencies are not allowed to operate in certain countries. Some employers' associations maintain employment offices, but experience proves that they are likely to degenerate into agencies for blacklisting active unionists and thus prove an obstacle to union organization and collective bargaining. Strong trade unions sometimes place their members through employment offices of their own, but this arrangement is of no assistance whatsoever to the non-unionists who constitute the great bulk of American wage earners. Philanthropic institutions, such as the Young Men's and Young Women's Christian Associations, frequently attempt to find jobs for applicants, but their scope of activity is necessarily limited.[28]

A Public Employment Service.—Students of the problem of unemployment are in general agreement that if we are to reduce unemployment to a minimum in this country, we must develop a public employment service that is comparable to the best that can be found in Europe. What is needed is a system of public employment exchanges that is large enough to cover the whole industrial United States. "Since the non-public agencies together fall short of meeting the quantitative needs of employment contact-making, since they leave important fields untouched which in the public interests should be provided for, and they are not well adapted to the requirements either of impartiality or of service on a coordinated national scale, we are led to conclude that the development of a national system of public employment bureaus seems to offer the greatest immediate promise of meeting the unified and growing wants of industry and the community."[29]

We Americans are not without experience in the business of finding work for the unemployed, for we established in January, 1918, the United States Employment Service, a public agency under the Department of Labor, which at one time had as many as 850 offices in operation throughout the country. Laboring under great handicaps, and with the opposition of private employment

[28] The pros and cons of private employment agencies are dealt with in some detail in Paul H. Douglas and Aaron Director, *The Problem of Unemployment*, pp. 266-281.

[29] Shelby M. Harrison, *Public Employment Offices*, New York, Russell Sage Foundation, 1924, p. 102.

bureaus and the National Association of Manufacturers,[30] the Service placed about two and a half million workers during its period of greatest activity, the year 1919. Later, however, the federal employment offices were taken over by states or municipalities, and the national government's part in the service was confined largely to providing federal aid and exercising general supervision over the several branches of the system. This arrangement was far from satisfactory. In many instances, the offices were poorly located and badly kept. The salary scale was usually inadequate, and the personnel often both incompetent and indifferent. There was little or no coordination and cooperation between the various exchanges, and no uniformity in record-keeping. No serious attempt was made to enlist the support and patronage of business men, who could frequently have rendered invaluable aid in finding work for the unemployed.

The Wagner-Peyser Act.—These are some of the defects which, coupled with the abuses practiced by the private agencies, led to the passage of the Wagner-Peyser Act in 1933. This Act attempted to remedy the situation by revamping the United States Employment Service, and having it operate a system of employment offices in cooperation with the states. The results have not been wholly satisfactory. It would seem better to have a chain of offices operated by the federal government than, as at present, for the federal government merely to give encouragement and aid to employment offices initiated by the several states. Among other things, there is need for a central clearing house of information, so that openings may not go unfilled when there are workers in other states who are able and willing to take the jobs. A nationally operated system of public employment exchanges appears to be one of the prime essentials to the solution of the problem of unemployment.

Planned Public Works

Another type of public aid that has been widely endorsed is the construction of needed public works in periods of business depression. Until recently we have been inclined to build our post offices and court houses, dig our sewerage ditches and subways, and construct state and national highways when business

[30] The private bureaus wished, of course, to eliminate competition, and the National Association of Manufacturers charged the Service with wastefulness, inefficiency, and *bias in favor of union labor.*

in general was booming rather than during hard times. This custom is doubly wasteful. First, since prices are high in periods of prosperity, the cost of public works built in these periods is correspondingly high. In the second place, and of particular importance in connection with unemployment, public construction, if carried on when business in general is depressed, would provide work for many thousands of jobless men. Moreover, the wages paid these men would constitute purchasing power for commodities in the making of which still others would find employment.

Possibilities of Relief Through "Public Works."—It is impossible to say just how much relief might be afforded by the planning of public works so as to level off the peaks and fill in the depressions of private business. To begin with, it must be confessed that we know very little about the total volume of public construction work in the United States. The estimates run all the way from one billion to two and one-half billion dollars' worth of building annually. Doubtless some of this work is urgent and must be completed at once, but there is unquestionably a part—and again we do not know how much—that could be delayed for a year or several years without social loss. If, during years of unusual business activity, a half or even a quarter of the work on public construction could be postponed and reserved for years in which employment is below normal, the effect would be most salutary. Not only would poor business be boosted by the adoption of this arrangement, but good business would be kept from running amuck. "In substance this type of control over public expenditures for construction is analogous to the attempts of central banks to control the volume of credit and through that the volume of business activity. Both methods contemplate the avoidance of inflationary practice; and both, in order to be effective, must come to an arbitrary decision regarding the proper rate of expansion of business activity, of industrial output, of bank credit, or of whatever criterion of inflation may be chosen."[31]

Shortcomings of Planned Public Works.—Our lack of data and the necessity of exercising arbitrary control are but two of the difficulties that are encountered in attempting to utilize the construction of public works in the stabilization of employment. Another obstacle to the smooth functioning of the plan is the rather narrow range of jobs available in undertakings of these

[31] Leo Wolman, *Planning and Control of Public Works*, New York, National Bureau of Economic Research, Inc., 1930, p. 173.

kinds. Though there may be an abundance of employment for skilled workers in the building trades, and sufficient work to keep thousands of pick-and-shovel men busy, it does not appear just how our displaced salesmen, clerical workers, silk weavers, shoe operatives, and factory employees in general can fit into the scheme. Public works offer little or no direct aid to the women in industry whom unemployment has left without incomes. Public construction, moreover, may be greatly needed in those sections of the country where unemployment is least acute, and may not be called for at all in areas in which the jobless are most numerous. Also, in some cases, much shifting of labor would be entailed, and this is both troublesome and expensive.

Even more serious is the lack of centralization of authority for public building projects, and the consequent inability to control public works through a federal agency. Unemployment of the cyclical type is usually country-wide—sometimes world-wide—and to apply the suggested remedy of planned public works with full success in the United States would require a central agency that not only knows of the contemplated public construction plans of the municipal, county, state, and national governments, but has the authority to modify these plans in the public interest. But the present situation is that the various governmental units control their own expenditures for public works, and ordinarily guard most jealously their rights in this respect. Since probably not more than 10 per cent of the routine public construction work in this country is under federal direction, the difficulties of developing a unified system of planned public works are obvious.

The several obstacles that appear to stand in the way of effective planning of public works for the relief of unemployment may eventually be surmounted. They are not presented as proof that a plan of this kind is unworkable, but simply to stress the fact that, despite the glowing optimism of its sponsors, this method of unemployment relief has yet to prove its feasibility.

The Roosevelt administration has given us an example of huge expenditure for public works—though, of necessity, hastily planned public works—for the purpose of relieving business depression and promoting recovery. The National Industrial Recovery Act of 1933 made available some four billion dollars for carrying out a public works program under the Public Works Administration; in 1935 nearly five billions more were appropriated by Congress

for promoting "relief work," most of which was used for conservation work, highway improvement, non-federal public works projects, low-cost housing, rural resettlement, and light construction work under the direction of the Works Progress Administration; and there were further large appropriations in later years. In some instances, the work done was of a strictly federal nature, such as the building of new post offices, but in many cases the government made outright grants to localities up to as much as 30 per cent of the cost of labor and materials on approved projects, and lent the balance at 4 per cent interest.

The chief object of these projects was, of course, to get money into circulation as fast as possible, to carry on undertakings which involved the use of much labor (so as to reduce the number of the unemployed), and to provide relief in the guise of work rather than as a direct dole. Since this is true, and since the work done was not a part of a carefully planned, long-run program of public works, it is probably true, as critics of the Roosevelt administration have charged, that a large part of the billions of dollars spent on "made work" was spent uneconomically. It is likewise true, as all social workers know, that indirect relief of the kinds noted above is more costly than a direct dole, if considered solely on the basis of dollars and cents expended; but it may well be worth the extra cost to give men jobs that are not very productive of economic goods, if by so doing we can avoid the loss of morale that goes with the long-continued acceptance of charity.

Unfortunately, this recent experience with public works in time of depression tells us little of what might be accomplished by means of a thoroughgoing program of planning of the kind which we discussed earlier in the present section. Though employment increased in volume during the progress of the programs carried on by the Public Works Administration and Works Progress Administration, it is impossible to say to what extent the decline in unemployment should be credited to these agencies. The fact that they provided direct employment to some millions of workers probably does not tell the whole story of their service in this respect. For the gain in employment in many businesses throughout the country must have been due, in large part, to the purchasing power placed in the hands of these publicly employed workers.

Unemployment Insurance

But it is not enough to attempt to stabilize business, to provide for public employment exchanges in order to make the most of whatever work is available, and to try to increase the amount of employment when it is most needed by encouraging public construction in periods of business depression. Despite our best efforts along these lines, it is evident that we shall have an unemployment problem on our hands for many years to come. This means that if we are to prevent distress and suffering in times of unemployment, we must undertake to provide the jobless with incomes large enough to enable them to buy a sufficient amount of food, clothing, and shelter.

Personal Provision and Private Charity.—Heretofore we have gone on the comfortable assumption that the American workingman, if he was industrious and thrifty, could so arrange his finances as to make the fat years take care of the lean. But each recurrent business depression, with its appeals for help for workers and their families, demonstrates the falsity of this assumption. Ordinarily we place the blame for lack of savings on the workers. "When the laborers' pockets are full, they forget that there is such a thing as empty pockets," is a common lament of the well-to-do. That fact is, however, that the vast majority of our workers have never experienced the luxury of a financial surplus. Two studies of the National Industrial Conference Board[32] (a business men's organization) present some illuminating data on this point. The first shows that the average weekly wage in manufacturing industries in 1927 was $27.44, or $1426.88 for a full year of fifty-two weeks. The second of these studies estimates the average minimum cost of living in twelve industrial cities in 1927 at $1556.[33] There is no need to point out the difficulty of providing for cyclical unemployment out of wages that, even in good times, are too small to buy a sufficient quantity of economic goods.

[32] *Wages in the United States, 1914 to 1927* (1928), and *The Cost of Living in Twelve Industrial Cities* (1928), National Industrial Conference Board, New York. For 1937, the National Industrial Conference Board estimated the average annual full-time wages at $1407.64 (average weekly wage, $27.07), and the cost of living at $1450.

[33] It is probable that these figures present a more favorable picture than the actual conditions warrant. Professor Douglas estimated the average wage for 1926 at $1376; and Professor W. I. King, for 1927, at $1205. Moreover, most social workers consider it impossible to maintain the hypothetical family of five in comfort for less than $2000 a year, with prices at the 1926 level.

Since these are *average* wages, there are some workers, of course, whose wages are more than adequate to take care of their *minimum* needs, but there are likewise some whose earnings in most prosperous times are too small to provide them and their families with a "decency" standard of living.

When those who are always impoverished fall upon the specially hard times of unemployment, we have expected charitable organizations to look after them; and when, as in the great depression of 1929, the resources of organized charity prove wholly inadequate, we have appealed to the public to contribute to relief funds. There are at least three serious objections to this method of procedure. First, the voluntary contributions are not always forthcoming, as is shown by the failure to raise a $5,000,000 relief fund in Philadelphia to meet the urgent needs of 1930-31. Second, this plan does not conform to the generally accepted theory that in meeting public obligations the burden should be distributed on the basis of ability to pay. When giving is "voluntary," some who could give millions give thousands or hundreds instead, and employed workers whose families need their entire earnings are virtually forced to give a day's pay a month, or some other amount set by an employer who wants his firm to show up well in the published list of contributions.

Finally, there is no disguising the fact that assistance coming from donations of this kind is charity, and no one who is able and willing to work should be humiliated by being asked to accept charity. Rather, he should receive whatever he gets as a *right*, and not as a gratuity. Perhaps the world does not owe anyone a living, but it may well be argued that it owes every man a *chance to earn a living*. Surely an industrial society that is so organized that men are denied the privilege of working can properly be charged with the responsibility of maintaining those from whom the means of livelihood are thus withheld. This point was emphasized by President Roosevelt in a speech made on the third anniversary of the passage of the Social Security Act of 1935, in which he said: "The millions of today want, and have a right to, . . . the assurance that with health and the willingness to work they will find a place for themselves in the social and economic system of the time."[34]

When emergencies arise calling for the expenditure of large sums of money, this money, though perhaps borrowed immedi-

[34] *New York Times,* August 16, 1938.

ately, should come ultimately from revenue derived from taxation. This is the one sure way of obtaining whatever funds are required, and the most likely way to spread the burden so that it will cause a minimum of sacrifice. In the case of unemployment funds, they should be paid to the jobless as a frank acknowledgment of society's failure to measure up to its obligation to provide work for those who want it. And society can scarcely be said to be discharging this obligation with undue liberality when it gives (as, according to Professor Paul Douglas, it gave during the post-1929 depression) its involuntarily unemployed an average of $20 per month per family.

The Principle of Unemployment Insurance.—But a better plan for enabling the unemployed to survive hard times has been used on a very small scale in the United States, and more extensively in Europe. We refer to unemployment insurance, which aims to apply to the problem of unemployment the well-known principle of risk-spreading. Unemployment, like fire and death, is the portion of some, but not all, in a given period, but no one can predict with certainty just which members of the group will be afflicted. It is possible, however, to insure against the economic dangers of an evil such as unemployment, through the regular collection of small premiums for all who *might* suffer temporary or permanent lay-off and consequent loss of income, and the payment of benefits to those to whom unemployment actually comes. The benefits that can be paid depend, of course, upon the size of the premiums, but care is always taken to see that these benefits are not so large as to make unemployment attractive to workers. In England the maximum benefits paid adult males have been $4.25 a week, with $2.25 for dependent wife and 50 cents per week for each dependent child. In Germany there have been various classes of beneficiaries, with benefits ranging from $2.50 to $15.00 per week and additional allowances for dependents.

It must be remembered, however, that the funds provided by collecting premiums may prove inadequate for the payment of promised benefits if the period of unemployment is unexpectedly extended and severe. This, for example, was the experience of the British, who found it necessary, upon the exhaustion of their unemployment "reserves" during the long post-war siege of unemployment, to pay "relief" benefits provided through receipts from taxation.

American Experience with Non-governmental Insurance Plans.—In most of the plans developed in foreign countries, the employers, the workers, and the state share in meeting the expenses of operation—that is, in paying what are, to all intents and purposes, the premiums. In the few non-governmental schemes that have developed in the United States, the costs are met sometimes by the employer alone and again by both employers and employees. A score or so of unions, with some 35,000 members, pay out-of-work benefits of $8.00 to $30.00 a week, but seldom for more than twelve weeks. About 50,000 employees of a dozen American companies are protected by either guaranteed employment or the assurance of unemployment benefits. All but one of the twelve are small, these eleven firms having a total of only 10,000 workers whose benefits in time of unemployment vary greatly. The large concern is the General Electric Company, which a few years ago had almost 40,000 workers covered to the extent of not more than $200 a year per worker. Joint employer-union insurance schemes have been set up in seven industries with about 70,000 employees in all. From this brief survey we see that only 155,000 American workers have any specific protection, through industrial insurance plans, against the economic hardship caused by unemployment.

Unemployment Insurance Under the Social Security Act of 1935.—The passage of the Social Security Act in August, 1935, marked the first attempt of the people of the United States to provide unemployment insurance on a nation-wide basis. Wisconsin and one or two other states had already adopted unemployment insurance, but the movement had been held back by the fear that in passing laws that made unemployment insurance compulsory a state would place its industries at a disadvantage in competition with industries in states which had no such laws.

The unemployment section of the Social Security Act solved this particular problem by imposing a federal tax of 1 per cent for 1936, 2 per cent for 1937, and 3 per cent per annum thereafter, on payrolls in general throughout the United States. The federal government itself does not provide unemployment insurance, but it encourages the states to do so, by allowing employers to credit as an offset against their federal tax any amounts which they contribute under an approved state unemployment fund, except that the total credit may not exceed nine-tenths of the federal tax for any given year. This one-tenth of the tax, which

must be paid to the federal government in any case, is used to assist the states in the administration of their unemployment plans.

Since the employers in every state must pay a 3 per cent payroll tax, either to the federal government or to the state and federal governments combined; since the federal government has removed the fear of putting the employers of one state at a disadvantage with those of another, by making the tax nation-wide; since it offers the states financial assistance in paying the costs of administering their insurance plans; and since none of the money will be spent within a state unless a local unemployment insurance plan is adopted, it is evident that a state has much to gain, and little if anything to lose, by giving its people the protection of unemployment insurance.

Average Amount of "Benefits."—In 1938, the Chairman of the Social Security Board announced that every state had adopted an unemployment insurance law; that twenty-eight states were already paying benefits, and the remaining states would reach full benefit-paying status within a year; that benefits for full-time unemployment averaged $45.00 a month, with a million jobless workers receiving checks averaging $10.00 a week; and that the total benefits to be paid out in the year 1938 were expected to reach approximately $400,000,000. Though there are considerable differences in the insurance plans adopted by the several states, it seems that in general an unemployed worker, after a waiting period of four weeks, may be expected to receive about 50 per cent of his previous weekly wages, with a minimum of $5.00 and a maximum of $15.00, and for a period of twelve weeks if he remains out of work for so long a time.

Among the specific standards to which every state insurance plan must conform are the following: The benefits that go to the unemployed must be paid through "public employment offices in the state or such other agencies as the Social Security Board may approve"; all monies received by the states in their unemployment funds must be paid over at once to the Secretary of the Treasury, to be placed in the Unemployment Trust Fund, and all money withdrawn by the states from the Fund must be used solely for paying unemployment benefits; benefits must be paid to those who would otherwise be eligible if these unemployed workers refuse to accept new jobs (1) because "the position offered is vacant due directly to a strike, lockout, or other labor dispute," (2) because "the wages, hours, or other conditions of the work

offered are substantially less favorable to the individual than those prevailing for similar work in the locality," or (3) because acceptance of the job involves signing a "yellow-dog" contract; and, finally, the states must reserve the right to alter the plans at will.

Shortcomings of the Plan.—In several respects, this federal provision for unemployment insurance falls short of meeting the needs of the country for protection against involuntary idleness. First of all, the Social Security Act fails to cover those workers who are employed in establishments not having a labor force of at least eight workers for at least twenty days a year (each day being in a different calendar week), and those workers who are employed by relatives. It excludes, also, all agricultural workers, domestic servants in private homes, officers and crews engaged in shipping in United States waters, public employees, and employees of non-profit-making organizations. Because of these exclusions, it is probable that not more than one-half of our "gainfully employed" population enjoy unemployment benefits under the Act. On this point, President Roosevelt said, in 1938: "To be truly national, a social security program must include all those who need its protection. Today many of our citizens are still excluded from old-age insurance and unemployment compensation, because of the nature of their employment. This must be set aright; and it will be."[35]

Another weakness of the plan at present is the lack of assurance that the laws of the several states will provide a high degree of security. For this vital matter is left entirely to the lawmakers of the individual states to decide. "The Social Security Act fails to specify, on just those points which matter most to the unemployed, what that compensation is to be. It lays down no standards concerning the minimum amount and duration of benefit, the length of employment necessary to qualify for it, or the waiting period that must elapse after unemployment begins before benefits are payable."[36] The result is that we have unemployment insurance of many varieties as between the several states.

The State's Part in Unemployment Insurance.—It is reasonable to suppose that if industries can build up surpluses from profits for the payment of dividends in lean years, as they now do, they can likewise afford to contribute, and should be compelled

[35] *Ibid.*, August 16, 1938.

[36] Eveline M. Burns, *Toward Social Security*, New York, McGraw-Hill Book Company, Inc., 1936, p. 88.

to contribute, to unemployment insurance funds from which benefits can be paid in periods of enforced idleness.[37] The compulsory feature of the Social Security Act is important, for American experience has shown that employers are slow to adopt social insurance of any kind, unless required to do so. In about one-half the states, the workers are required to contribute toward the building up of an unemployment reserve; and in most of these cases the employees' payments are approximately one-half as great as the employers'.

But it seems desirable that the federal government also should contribute to the unemployment reserve funds, not only to make possible the payment of larger benefits, but also to emphasize its responsibility in failing to remedy cyclical fluctuations (which, as we have seen, are not directly chargeable to individual concerns) and to justify the control of these reserve funds by the government. Unemployment is not only a local but a national problem as well; and we feel strongly that unemployment insurance, like public employment exchanges, should be administered on a country-wide basis by a federal agency.

Conclusion.—In dealing with the problem of unemployment, we have often been able to give only a page or two to the description of phases of the subject about which whole volumes have been written. Our treatment represents, therefore, only the barest outline of the problem and the plans proposed for its solution. The seriousness of the unemployment problem is undeniable. So far as remedies are concerned, there is little that can be said with assurance. The truth of the matter is that we are just beginning to give this problem the attention that it deserves. What does seem reasonably clear is that in relatively few cases are the workers themselves responsible for unemployment or for the lack of savings to tide them over the period of enforced idleness. The responsibility lies, rather, with individual employers and the industrial system as a whole. Consequently, it is the duty of business men and of the state to see to it that the volume of unemployment is cut down materially, and that whatever part remains shall not be allowed to bear too heavily upon those affected. It is believed that earnest attempts to stabilize business, to control the construction of public works, to improve our facilities for the retraining of

[37] Dividends and interest paid in the United States were $428,500,000 greater in 1930 than in 1929, while wage payments fell off $9,600,000,000, according to estimates of the Standard Statistics Company.

workers, to provide jobs through public employment exchanges, and to develop a sound system of unemployment insurance, can do much to solve this most serious of the several problems of economic insecurity.

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1. "One of the distinctive features of modern economic life is the separation of the worker from ownership of the tools with which he performs his daily tasks." What has this fact to do with the problem of unemployment?
2. "The loss of a job may spell tragedy." Why? Describe the sort of tragic consequences that result from the inability to get steady work.
3. How extensive was unemployment in the United States in 1933? How large is the army of the unemployed in times of prosperity?
4. Distinguish carefully between the several types of unemployment.
5. In what years in the twentieth century has cyclical unemployment been especially severe?
6. Name several industries in which production is highly seasonal, and explain why it need be seasonal in these particular industries.
7. Professor Slichter speaks of technological unemployment as consisting of *permanent lay-offs*. Describe the most important causes of such lay-offs.
8. Stuart Chase has written an article about a gigantic new machine which turns out 10,000 automobile frames a day. "When those frames were made by the old 'hand' process," he says, "it took 2,000 men to produce 10,000 frames a day. The machine has eliminated 90 per cent of the sometime operating force."
   (a) What type of unemployment has been caused by the use of the machine?
   (b) Is it probable that the displaced workers will be permanently unemployed?
9. Summarize Dr. Lubin's study of job-hunting by laid-off workers.
10. Are *permanent lay-offs* and *permanent unemployment* synonymous? Explain.
11. Explain Mr. Lewisohn's statement that "employment may be due to bad management which creates seasonal unemployment or good management which causes technological unemployment." If this statement is correct, should we not welcome rather than decry technological unemployment?
12. In what ways are private employment agencies inferior to a nation-wide system of public employment exchanges?
13. What was the purpose of the Wagner-Peyser Act?

14. Discuss the public works programs of the federal government in the post-1929 depression.
15. What are the advantages of relief through public works as compared with a direct dole? The disadvantages?
16. Describe briefly the unemployment insurance provisions of the Social Security Act of 1935.
17. State the defects of this plan for unemployment insurance.
18. What can be said for and against a system of unemployment insurance, financed wholly by the employers and the state, with benefits paid as a *right* of the unemployed and not as *charity*?

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4 ECONOMIC INSECURITY: ACCIDENTS, SICKNESS, OLD AGE

WE CONTINUE IN THIS CHAPTER OUR EXAMINATION OF THE PROBLEM OF ECONOMIC INSECURITY, OF WHICH UNEMPLOYMENT IS a major item. But whereas in dealing with unemployment we were considering men and women who are both able and willing to work, if only they are given the opportunity, in the case of accidents, sickness, and old age we direct our attention to those who either are physically incapacitated or have reached the age limit beyond which industry has no use for them. The economic consequences are here much the same as the consequences of unemployment. Without jobs, whatever may be the cause, these "dislocated soldiers of industry" are likewise without incomes, and lacking incomes they are faced with the problem of needing economic goods but having no purchasing power. The problem here, therefore, as in all instances of economic insecurity, arises from the fact that human wants continue as long as life itself regardless of whether the means of satisfying these wants are available.

Industrial Accidents

The Terms "Accident" and "Injury."—In discussing the subject of industrial accidents, it is rather common practice to use the words "accident" and "injury" as though they were synonymous. Mr. H. W. Heinrich, a leading authority on accident prevention, points out that this is by no means true, and that much confusion may be avoided by a correct use of the terms.[1] An accident, says the lexicographer, is "an event that occurs without one's foresight," whereas an injury is "any wrong, damage, or mischief done or suffered." Happily, not all accidents result in injuries. And yet, such data as we have relate almost exclusively to industrial *injuries* which are almost invariably referred to as industrial *accidents*. The significance of the dis-

[1] H. W. Heinrich, *Industrial Accident Prevention*, New York, McGraw-Hill Book Company, Inc., 1931, pp. 90-93.

tinction will appear in our treatment of the costs and prevention of accidents.

The Number of Industrial Injuries.—Our records of industrial accidents are far from satisfactory. In four states (Arkansas, Florida, Mississippi, and South Carolina) no records are kept of industrial accidents or injuries, and in the other forty-four states the figures relate chiefly to injuries for which benefits have been paid under the workmen's compensation acts. But a careful study of such information as we have leads to the estimate that there are some 24,000 fatal industrial accidents in the United States annually, 3,000,000 industrial accidents causing injuries that result in some loss of time, and more than 80,000,000 minor industrial accidents resulting in injuries that require but little attention. Since "for each accident producing a personal injury of any kind (regardless of severity) there are at least ten other accidents,"[2] we arrive at the conclusion that some 800,000,000 *accidents* occur in American industry every year. In the State of Pennsylvania, which has developed an excellent system of safety work, there were 1029 industrial fatalities and 84,616 non-fatal injuries in 1933. Slightly less than one-half of Pennsylvania's fatal accidents are chargeable to the coal-mining industry.

Direct and Indirect Costs of Injuries.—If we try to express these industrial injuries in terms of monetary cost, the figures arrived at are appalling. Under compulsory state legislation, more than $240,000,000 in benefits is paid out annually to those who have suffered industrial injury, or to their dependents, and more than $70,000,000 additional for medical services. The payments in New York State alone in 1935 amounted to $25,405,110, for a total of 69,770 injuries. But compensation payments represent only a fraction of the total costs. Professor Edison L. Bowers estimates that all types of industrial injuries taken together cause an annual loss of more than 280,000,000 working days, and a wage loss of over a billion dollars. When compensation payments, wage losses, the costs of medical attention, and indirect losses in production are brought together, the total annual loss, Professor Bowers feels, can scarcely be less than four billion dollars.[3]

The importance of *indirect* as compared with *direct* costs of

[2] For the calculations by which these estimates are reached, see *ibid.*, pp. 16, 90, 91.

[3] Edison L. Bowers, *Is It Safe to Work?* Boston, Houghton Mifflin Company, 1930, p. 5.

industrial injuries is frequently overlooked. It is easy to see that payments for workmen's compensation and medical care for the injured are costs that are entailed by the failure to prevent accidents. But it has been found, by analysis, that these direct costs are not more than one-fourth as great as the indirect or "hidden" costs that must be met by the employer, but often are not charged against industrial accidents. The items of indirect costs—that is, those costs over and above payments for compensation and medical aid—are time lost by injured employees but paid for directly by the employer, time lost by other employees (out of curiosity, sympathy, or desire to assist), time lost by foremen and superintendents, spoilage of material, breakage of tools, and so on. Table 3, which is made up from nine cases taken from actual experience,

TABLE 3.—DIRECT AND INDIRECT COSTS OF INDUSTRIAL INJURIES[a]

Accident No.	Type of Industry	Direct Costs	Indirect Costs
1	Building construction..........	$209.00	$ 937 00
2	Hardware manufacture........	66.00	275.00
3	Not specified..................	0.00	154.00
4	Woodworking plant......	59.00	262.00
5	Machine shop................	11.00	49.00
6	Trucking.....................	25 00	140.00
7	Woodworking plant...........	86.50	379 50
8	Clothing manufacture.........	50 00	230.00
9	Drop-forge plant.............	22.00	107 00
	Total.	$528.50	$2533 50

[a] Source: H. W. Heinrich, *Industrial Accident Prevention*, pp. 19–27.

shows the monetary significance of the indirect costs of industrial injuries. With cases such as these before us, it is not hard to believe that the "by-products" of industrial accidents are four times as costly as the compensation and medical payments.

We must not quit the subject of costs without reference to the *human* costs involved in industrial injuries. Costs of this kind are, of course, quite incalculable. It is true that state compensation laws undertake to evaluate arms, legs, eyes, and other scraps of human anatomy in terms of dollars and cents; but who would feel fully recompensed if he received in exchange for an arm, as he would in Ohio, a maximum of $18.75 a week for two hundred weeks? To the personal costs of suffering and lifelong physical impairment must often be added a serious loss in earning capacity,

and consequently a lowered standard of living. Here are human costs that affect not only the injured man, but bear heavily upon his wife and children as well, as we noted in our study of unemployment.

The Causes of Industrial Accidents.—Industrial injuries result from industrial accidents, but what are the causes of the accidents themselves? Until we have found the answer to this question we lack the knowledge that is essential to the prevention of industrial casualties of this sort. Nor is it enough to know that the injury was brought about by a fall, a blow, or an explosion. We must know what caused the fall, or blow, or explosion, before we can hope to prevent such accidents in the future. The best practice, therefore, in analyzing the conditions that lead to human injuries is to work back from the *injury* ("the wrong, damage, or mischief done or suffered") to the *accident* (the "event that occurs without one's foresight") and thence to the *cause* of the accident, to the end that the cause may be removed and a repetition of the accident prevented.

Contrary to popular notion, industrial accidents are not very largely the result of unguarded machinery, open elevator shafts, defective ladders, and other unsafe working conditions that might easily be remedied. It is doubtless true that such causes were once responsible for many and serious injuries, but progress in managerial methods and state legislation have wrought remarkable changes in the physical equipment with which men now work.[4] In seeking the causes of industrial accidents, we cannot do better than examine a study of 75,000 cases analyzed by the Travelers Insurance Company. This investigation disclosed the fact that, according to the customary but improper method of analysis, 25 per cent of these accidents would have been charged to physical or mechanical causes in the plant, but that in reality many accidents falling within this 25 per cent were attributable, wholly or in part, to faulty supervision. The conclusion finally reached was that 10 per cent of the 75,000 accidents were properly chargeable to physical causes, 88 per cent to supervisory causes, while 2 per cent only were classed as unpreventable.

Since the number of cases entering into this study was sufficiently large to constitute a fair "sample" of industrial accidents in general, we shall note very briefly the physical and supervisory

[4] As witness the elaborate and ingenious safety devices described by picture and print in H. W. Heinrich, *Industrial Accident Prevention*, pp. 143-243.

shortcomings that accounted for these 75,000 accidents. The physical causes listed were unguarded and ineffectively guarded mechanical, electrical, steam, and chemical conditions; congestion and faulty storage of materials; defective machines, tools, and materials; inadequate fire protection and exits, and unsafe floors and openings; improper ventilation, sanitation, and light; faulty layout of operations and machinery, and unsafe processes; and unsuitable dress (such as long sleeves and high heels) and the absence of goggles, gloves, and masks. The defects on the side of supervision were faulty instruction; inexperience, lack of skill, ignorance, and poor judgment of employees; poor discipline, including disobedience and "fooling"; inattention and the distraction of attention; such unsafe practices as "chance taking," haste, and "short cuts"; mental unfitness, including fatigue, violent temper and excitability; and physical unfitness, such as bodily defects, weakness, and fatigue.[5]

Industrial Accident Prevention.—Even though we assume that the cases investigated by the Travelers Insurance Company are strictly representative, and that as a consequence 98 per cent of *all* industrial accidents are preventable, it is too much to expect that so high a percentage will actually be prevented. "Some persons, and among them not a few safety engineers and government officials, feel that the limit has been reached in accident elimination; that information about injuries, both fatal and non-fatal, from now on, must be received as a matter of course. . . . But such an assumption seems to be unwarranted."[6] Mr. Heinrich believes that "it is entirely possible and practicable to achieve *at least a 50-per-cent reduction in present accident frequency and accident cost* and that this may be accomplished speedily with very little expenditure of money and by the use of executive machinery which is already established."[7] Even more optimistic is the Committee on Elimination of Waste in Industry of the Federated American Engineering Societies. The estimate of this Committee is that 75 per cent of all loss from industrial accidents could be eliminated if proper attention were given to accident prevention.[8]

Certainly the records of some of the achievements in accident prevention are most encouraging. The United States Steel Cor-

[5] For the details of this important study, see *ibid.*, pp. 44-49.

[6] Edison L. Bowers, *Is It Safe to Work?* p. 15.

[7] H. W. Heinrich, *Industrial Accident Prevention*, p. 64.

[8] *Waste in Industry*, New York, McGraw-Hill Book Company, Inc., 1921, p. 332.

poration eliminated 64 per cent of its serious accidents in the period from 1906 to 1929, and 88 per cent of loss-of-time injuries, thus saving 58,533 men from serious injury and 433,205 from injuries that would have caused them to lose some time. By means of accident prevention work, the Fisk Rubber Company saved 10,120 men from injury from 1918 to 1929, preventing loss of wages to the amount of $700,000 and saving $300,000 in compensation insurance premiums. The Boston Elevated Railway succeeded in reducing the *number* of accidents, from 1927 to 1928, by 20 per cent, and in cutting the *cost* of accidents by 33 per cent.[9] The effectiveness of accident prevention work is often reflected in the rates charged for workmen's compensation insurance. For example, the quarry insurance rate in Pennsylvania is $3.60 per $100.00 of payroll; in Alabama, $4.77; Indiana, $5.32; Illinois, $6.57; Kansas, $7.44; Georgia, $7.76; Maryland, $7.99; and New York, $9.87. It can scarcely be doubted that the low rate in Pennsylvania, which is the lowest in the United States, is related to the admirable safety work that is conducted in quarrying in that state, and which from 1926 to 1928 brought a decrease of 22 per cent in fatal accidents and 14.5 per cent in non-fatal injuries.

We cannot undertake to discuss the details of accident prevention, but must be content to indicate the general principles which have been applied successfully in bringing about reductions in accidents and injuries. Mr. Heinrich lists four such principles: (1) the development of executive interest and participation; (2) accurate analysis of causes; (3) selection and application of remedies; and (4) the enforcement of corrective practices. The point of attack should be the accidents that occur, and not merely the injuries suffered. Not only lost-time accidents, but *all* accidents, whether or not they result in injuries, are worthy of investigation. If a workman falls but is not hurt, good practice demands that the cause of his fall be studied, since the fall constitutes an *accident* which, if repeated, might easily result in injury. "In prevention work, the importance of any individual accident lies in its *potentiality* of creating injury and not in the fact that it actually does, or does not, so result."[10] Every accident, then, must be investigated and its cause determined, measures to prevent its recurrence must be devised and adopted, and the executives must see to it that the precautions prescribed are rigidly adhered to.

[9] H. W. Heinrich, *Industrial Accident Prevention*, pp. 8, 9.
[10] *Ibid.*, p. 88.

It is only by strict adherence to a definite program that business concerns achieve great reductions in accidents and injuries such as have been cited.

Workmen's Compensation.—But the best that can be done in the way of preventing accidents will leave the problem only partly solved. For the total elimination of occupational injuries seems to be unattainable, and so long as any industrial casualties of this kind occur there will be doctor's bills to pay and families to provide for in the event of death or during the period of recovery. Forty-six states have decided that the employers of the injured workers shall help to meet these expenses. In these forty-six states, compulsory workmen's compensation laws have been enacted, requiring the employers to provide in advance for the payment of a proportion of wages to their employees when the latter are unable to work because they have suffered industrial injury. In addition to the state laws, there are three Federal Compensation Acts, one providing for payments by the government to any of its employees who may be injured, and the other two specifying the compensation that is to be paid by employers to harbor workers, and to workers privately employed in the District of Columbia, respectively, in case of industrial accidents resulting in injury.

There are many workers in the United States, however, who are not covered by workmen's compensation laws. Most of the state laws make no provision for farm labor, domestic help, and itinerant or casual workers. Workers in industries of special importance in particular states are in some instances deprived of this protection. Those employed in logging in Maine, cotton-ginning in Texas, and distilling in Kentucky are specifically excluded from the benefits of compensation laws; and some 1,500,000 transportation workers, because they are in *interstate* and not *intrastate* commerce, are not covered by compensation legislation. Concerns employing not more than three workers in Ohio, four in New York, and sixteen in Alabama, are not required by their respective states to pay compensation to injured employees, unless the employees are able to get awards through civil suits.[11] Taking the country as a whole, it seems probable that about 80 per cent of all the workers are given protection under the several compensation laws.

The amount of protection enjoyed varies considerably from

[11] Edison L. Bowers, *Is It Safe to Work?* p. 20.

state to state. Disability benefits usually take the form of weekly payments extending over a stated period of time. The laws specify that the payments shall consist of a certain percentage of the worker's regular weekly wage. In this matter there is no uniformity between states, the percentage depending upon the liberality of the law, the type of injury sustained, and the number of persons being supported by the injured worker. In most states there is a maximum limit to the amount of the weekly payment that an employee may receive as compensation, with the result that the actual payment is often considerably less than the percentage provision of the law. The *percentage*, for example, may be 66 2/3, and the *maximum limit* $20.00 a week, in which event a worker whose regular wage is $45.00 would draw not 66 2/3 per cent of that amount, or $30.00 a week, in compensation, but only $20.00 (the maximum prescribed by law), or 44 4/9 per cent of his usual income.

The number of payments that can be collected depends, again, upon the nature of the injury. In Ohio, the loss of an arm means 200 weeks of compensation; the loss of a leg, 175 weeks; of a hand, 150 weeks; a foot, 125 weeks; an eye, 100 weeks; and a thumb, 60 weeks. In most states there is a maximum period for the payment of benefits, regardless of the seriousness of the injury. The highest maximum is 520 weeks in Connecticut, and probably the lowest is the 150 weeks in Idaho. Moreover, it is customary to set a maximum monetary award for partial disability, which is occasionally as high as $5000, but is more often considerably less. Death benefits, under workmen's compensation acts, are frequently as high as $5000 or $6000, though here, again, there is no uniformity as between states. The payments made to United States government employees are somewhat more liberal than the compensation provided for by state laws. An injured government worker receives two-thirds of his regular wages (with a monthly maximum of $116.66) during the period of total disability, and after his return to work a payment amounting to two-thirds of the difference between his earnings before and after the injury. In many instances, of course, he is able to return to his former job or take a position equally well paid, in which case compensation stops immediately.

Proposed Changes in Compensation Procedure.—No one who knows the facts can fail to see that the present situation is socially a vast improvement over the chaotic state of affairs that

existed before the passage of workmen's compensation laws. In those dark ages the payment of benefits was either voluntary on the part of the employer or contingent upon the injured worker proving in court that the employer was legally responsible for the accident and liable for damages. The uncertainties and costliness of litigation led to the frequent settlement of claims, out of court, for pitifully small sums. A major injury, such as the loss of an arm or leg, might result in the payment of a few dollars or hundreds of dollars, or at times in no payment at all; and there are many instances of death claims being settled for as little as $100, or even less. The elimination of the need to prove the employer's responsibility, and the much larger awards that are now made, constitute real progress in the handling of this particular problem of economic insecurity. The fact that workmen's compensation is now taken as a matter of course and is generally regarded as an essential feature of our industrial system, is a striking illustration that sweeping changes in labor legislation may, when they are being made, give rise to loud and bitter protests, and yet in the course of a few years be accepted as wholly beneficial to all concerned, for compulsory workmen's compensation had its beginning in the United States only about twenty-five years ago.

But though the situation is greatly improved, our method of dealing with industrial injuries today is still far from perfect. For a system to be entirely satisfactory it must, first of all, provide abundantly for the economic needs of the injured worker and his dependents, and, in the second place, supply an incentive sufficiently strong to effect a steady reduction in the number and severity of injuries. In view of the amount of compensation provided by the average state law, we can scarcely claim that we "provide abundantly" for those injured by industrial accidents. Since the maximum weekly benefits range from $12 to $25, or $624 to $1300 per year, while the amount necessary for the maintenance of a minimum standard of living is set by experts at $1500 to $2000 a year, the inadequacy of the payments is obvious. Moreover, the maximum number of weekly payments and the maximum monetary award specified by law do not guarantee, by any means, that even the payments of $12 to $25 a week will extend over the whole period of disability. In twenty states only does compensation continue for life in the event of total disability. Medical service, which is provided for in all compensation laws except that of Arizona, is often quite inadequate, being limited in some in-

stances to a few weeks or months, and, again, by a maximum expenditure of a very moderate amount, say $150 or $200. Death benefits are definitely limited in all but seven states, amounting usually to about three times the annual earnings of the deceased.

When workmen's compensation first gained prominence in this country, it was hoped and confidently expected that the desire to keep insurance rates down to a minimum would lead employers to guard the safety of their workers so diligently that the number of industrial fatalities and injuries would be materially reduced. It is impossible to say definitely to what extent the introduction of workmen's compensation has furthered the good work of accident prevention. Certainly the predictions that were made by the early champions of compulsory compensation have not been fully realized. Some excellent prevention work has been done, as we have seen. But in many plants production seems to be conducted in much the same manner as before, with little attention given to safety work, and insurance premiums charged against costs of production as a necessary and unavoidable expense. It would appear, then, that employers in general are not yet convinced that it is cheaper to prevent accidents than to pay compensation. We have failed, therefore, to meet the second requirement of a sound system of accident compensation, which, as we have already noted, is to provide an inducement that will lead employers to give proper attention to the prevention of industrial accidents.

It seems probable that the goals of *adequate compensation* and *accident prevention* can best be reached through the agency of a substantial increase in compensation benefits of all kinds. This increase would not only add to the comfort of the injured workers and their families, but, unless it was accompanied by a sharp decline in the number and seriousness of injuries, would inevitably be paralleled by a material increase in insurance rates. By making accidents very expensive to employers, it should be possible to arouse wider interest in thoroughgoing safety work. For the arrangement to work out satisfactorily, it would be necessary to continue the use of a principle now employed in many states—that of making adjustments in insurance premiums, so that concerns having a heavy casualty record are required to pay high rates, and those having few workers injured each year pay much lower premiums. In this way, the burden is placed where it rightly belongs, on the careless, irresponsible firms; and it is probable that, if the benefits were increased materially, the necessity of meeting

these high payments would either force these unprogressive concerns to mend their ways, or drive them out of business.

The extent to which benefits would have to be raised in order to provide adequate compensation and stimulate accident prevention would be determined by careful investigation and experimentation. There is much to be said for continuing a man's wages *in full* during the period of his total disability, so that he and his family shall not be compelled to lower their standard of living. If, upon recovery, he is unable to perform his old tasks and must accept low-paid work, he might well expect to have his loss made up by the payment of compensation benefits. There is, of course, the danger of malingering to be guarded against; but it is much more difficult to feign accidental injury than industrial illness, and this is a type of abuse that can be prevented very largely by an efficient system of medical examinations. Death benefits should certainly be increased materially, and should be based upon the capitalized earning power of the deceased and the number and ages of his dependents.

If it should appear that increases in benefits such as are here suggested would bear too heavily upon industry, the answer is that one reason—and a most important reason—for making the increase is to render industrial injuries so costly that they will not be tolerated. If 50 to 75 per cent of our industrial accidents can be prevented, as experts firmly believe, and if accident prevention lies within the province of the employer, as it clearly does, then it is high time to bring pressure to bear upon American business men so that they will cease to ignore this vital problem. Doubtless the best antidote for indifference is a heavy addition to the costs of operation of those employers who refuse to turn over a new leaf.[12]

Rehabilitation of the Injured.—"Prevention, compensation, and rehabilitation" is the battle cry of those who are warring against industrial accidents. Prevention, of course, would be the best of all possible solutions of the problem. But complete prevention is apparently unattainable, and in its absence there is sore need for compensation and rehabilitation. Of prevention and compensation we have already said enough, but we must not close our discussion without some reference to the possibilities of industrial rehabilitation.

[12] An increase in benefits, of the type here outlined and for the purposes set forth, is strongly advocated by Professor Bowers. See *Is It Safe to Work?* chaps. 11, 12, and 14.

It is socially desirable that the victims of industrial accidents be accorded such treatment as will enable them to resume productive work promptly. In many instances, however, a complete recovery does not mean that the worker is ready for a job, for the seriousness of the injury may preclude the possibility of a return to the old occupation. The loss of a hand, an arm, or an eye may completely incapacitate a worker in so far as the performance of his former duties is concerned. Rehabilitation is defined by law as "the rendering of a physically handicapped person fit to engage in a remunerative occupation." The great need for assistance of this kind is indicated by an estimate of the Director of the Federal Board for Vocational Education to the effect that there are some 200,000 persons permanently disabled in the United States annually. Some of these are hopelessly crippled and cannot work again, some are able to resume their old jobs fairly soon, and still others—estimated at some 55,000 persons—need help in getting into employment by means of which they can support themselves.[13] But the number actually rehabilitated is only about 5000 a year.

The work of rehabilitation is carried on by the states in cooperation with the federal government, by authority of an Act passed in 1920. The states are granted federal aid on the basis of population, each state supplying from its treasury an amount equal to that provided by the federal government, and the task of training workers for new occupations is carried on under the direction of the Federal Board for Vocational Education. Mr. Wright, former director of the Board, has outlined the work of rehabilitation as consisting of (1) locating the persons who need training, (2) advising with them about the kinds of jobs in which they would be happy and for which they are fitted, (3) training them for the selected jobs, (4) finding openings for them in industrial plants, and (5) following up the cases for six months to two years to make sure that the rehabilitation has been satisfactorily completed.[14] Strangely enough, those who need rehabilitation often have to be urged to accept the assistance which is available without cost. This fact probably accounts in large measure for the limited effectiveness of the work, which at present is reaching only about 10 per cent of those who need aid of this kind. Rehabilitation

[13] See J. C Wright, "Rehabilitation in Industry," in *Unemployment and Adult Education (A Symposium)*, pp. 49, 50.

[14] *Ibid.*, pp. 49, 50.

work will doubtless increase in popularity when it becomes more widely known that most of the men and women who have been rehabilitated are able to earn more now than before they were disabled. The federal Social Security Act recognized the importance of this work by increasing by approximately two million dollars a year (beginning in 1937) the federal appropriations to be used for purposes of rehabilitation of the disabled.

Sickness

Sickness is very similar to unemployment and industrial injury in its economic consequences. The man who is without work from any of these three causes is likewise without income and, unless some system of aid has been provided, may gradually sink to the depths of poverty. In an economic sense, sickness and injury are even more serious than unemployment, since they add the burden of medical costs to the worker's regular expenses of maintenance.

The Extent and Cost of Sickness.—Our information as to the extent of sickness in the United States, like most of our information on conditions of social welfare, is extremely meager. Here again, as in so many instances, we have to fall back upon estimates. But if these estimates come anywhere near the truth, we can no longer afford to ignore this phase of the problem of economic insecurity. From a study of some 500,000 persons in 1926, Dr. L. I. Dublin concluded that 2 per cent of the people in the United States are constantly sick, and that the average worker loses about seven days of employment annually because of sickness.[15] Dr. John A. Lapp, in a more recent statement, estimated that about 8,400,000 workers are annually disabled by illness lasting more than seven days. About 65 per cent of this number, he felt, are sick for less than thirty days, the other 35 per cent being incapacitated for a longer time than this. He estimated, further, that 250,000 annually are kept from work by sickness for more than six months, and at least 120,000 for the full year.[16] Professor Abraham Epstein, who has written extensively on the subject, says that "from 2,500,000 to 3,000,000 persons are ill in the United States every day."[17] The loss in wages is placed by the National

[15] L. I. Dublin, "Economics of World Health," in *Harper's Magazine*, November, 1926, pp. 734-741.

[16] J. A. Lapp, "Advantage of Insurance in Disability, Illness, and Old Age," in *American Labor Legislation Review*, June, 1928, p. 182.

[17] Abraham Epstein, "Health Insurance—the Next Step," in *New Republic*, February 17, 1937, p. 35.

Industrial Conference Board at $250,000,000 a year, and by Professor Irving Fisher at $500,000,000. Dr. Dublin believes that the total loss in current production runs to more than $1,250,000,000 per year, and that another billion dollars must be added to cover medical costs. We may note, finally, the estimate of the late Dr. I. M. Rubinow, who held that "the economic loss resulting from illness is at least five or six times as great as that due to industrial accidents"[18]

The Need for Public Action.—In view of these terrific economic losses, not to mention the human suffering involved in such widespread sickness, it is surprising that we have done so little in this country to remedy the situation. We have had, to be sure, anti-spitting laws and anti-tuberculosis campaigns; health pamphlets issued by insurance companies and health hints written by newspaper columnists; a limited number of public clinics for the poverty-stricken, and free medical service for the employees of a few progressive firms; sick benefits through trade unions, and health insurance provided by a handful of employers. But our attempts to safeguard the average citizen against ill health, and to indemnify him for economic loss when sickness lays hold upon him, have been, on the whole, quite haphazard.

There can be little doubt that our tradition of individualism has been a serious obstacle to the development of a program of health conservation and insurance in the United States. Custom has decreed that whoever can pay must meet his own doctor bills, and, in the absence of ability to pay, either the pride of the needy or the unwillingness of doctors to work without pay has often stood in the way of sick persons getting much-needed medical attention. "Caught between two millstones—loss of wages and unbearably heavy sickness costs—the sick American wage earner first tries to get along with as little medical care as possible. When this can no longer be done, his alternative is private or public charitable medical relief. A compilation of sickness surveys in twelve communities in the United States, made by Dr. Michael M. Davis, disclosed that from 25 to 30 per cent of the relatively serious cases of sickness had no physician's care. In the rich city of Rochester, New York, 39 per cent of the persons suffering from disabling illness had no doctor in attendance. The Committee on the Cost of Medical Care concluded: 'Each year nearly one-half of

[18] I. M. Rubinow, in Kirby Page, editor, *A New Economic Order*, New York, Harcourt, Brace & Company, Inc., 1930, p. 167.

the individuals in the lowest income group receive no professional medical care or dental attention of any kind, curative or preventive.' "[19]

Cooperative Health Service.—In comparatively recent years, an attempt has been made to provide relief through the agency of cooperative systems of health service, enabling a family to provide for its medical needs by paying a stated sum over a specified period of time, say a year. For quite a while, the officials of the American Medical Association were outspoken in their opposition to schemes of this kind, apparently wishing to keep their business relationships with their patients on an individual basis, and to charge for each item of service rendered rather than to make a set annual charge. However, there has been increasing insistence, on the part of both physicians and the public, upon the expansion of cooperative health service. The American Institute of Public Opinion made a survey in 1938, which showed that seven out of ten doctors favored the adoption of a plan which, through regular payments to a health fund, would assure necessary medical and hospital care to an individual or family; and that 53 per cent of the population were willing to pay a satisfactory charge—say, $2.00 a month per person—in order to be certain of having complete medical and hospital care when it was needed.[20]

The Case for Socialized Medicine.—Though cooperative health service would be a great advance over the situation that exists today, and would mean better health and longer life for many, it seems evident that many millions of our poorer citizens could not pay even the modest charge proposed in most plans of this kind. For those in the lowest income groups, adequate medical attention seems to be out of the question unless it is provided without any charge whatsoever. The advocates of socialized medicine argue that, since the public health is scarcely to be regarded as less important than general education, there is no good reason for not socializing our health service as we have socialized our grade school and high school education, providing medical advice and treatment and free hospitalization for all who need them, at the expense of the state. They even insist that, far from being a costly piece of social engineering, a health program of this sort would be a great money-saving venture, cutting down materially

[19] Abraham Epstein, "Health Insurance—the Next Step," in *New Republic*, February 17, 1937, p. 35.

[20] *New York Times*, June 15, 1938.

the loss in total national income which we now suffer because of sickness. That such a program, properly carried out, would reduce the death toll is indicated by the statement of Dr. Russell L. Cecil, of the Medical Society of New York State, to the effect that "25,000 to 30,000 lives might be saved annually in this country if inexpensive or free pneumonia serum were generally and quickly available."

The federal Social Security Act allotted $10,000,000 a year for the prosecution of the public health. One-fifth of the appropriation goes to the Public Health Service for carrying on research work. The remaining $8,000,000 is to be divided among the several states on the basis of population, health needs, and financial condition. These federal funds will not directly aid the average citizen in securing medical service or hospitalization, however helpful they may be in raising the health standards of local communities.

Wage Payments During Illness.—Leaving, now, the question of whether medical and hospital care are to be provided individually, cooperatively, or socially, we shall examine briefly the problem of indemnifying the workers for the loss of income resulting from the inability to perform their daily tasks. There has been much argument as to whether this should be done at all, and if so, to what extent and at whose expense. An examination of the situation seems to indicate that sickness benefits should and must be paid to ailing workers, if we are to have a system of health preservation worthy of the name. Industrial workers usually feel that they cannot afford to quit their jobs on account of illness as long as they are able to "keep going." As a consequence, we have many workers in our stores, offices, and factories who should be at home under a physician's care; and the result is that "common colds," influenza, and other diseases take a far heavier toll than need be. Until we make it easy for the sick worker to get to bed, we have not adequately protected those who will have to work with him and ride beside him in crowded street cars if he tries to carry on. We believe, therefore, that a sound public health program must include provision for the payment of sickness benefits that will permit workers to get rest and treatment in the early stages of their illness. The possibility of malingering must not be allowed to interfere with this essential feature of health conservation, for there are ways of guarding against it, and even at its worst it is far less expensive than epidemics.

Who Shall Pay the Bill?—In arranging for the financing of these sickness benefits, it is commonly suggested that we might well follow the lead of the principal European countries, which have installed systems of compulsory health insurance calling for contributions from both employers and employees. In Russia, it is true, the government bears the whole cost of the insurance; but in Great Britain, Germany, France, and Hungary, the employees pay at least one-half and sometimes two-thirds of the premiums, the remainder being provided by the employers. In Great Britain there is also a small contribution from the state. By paying 9 cents a week, a British male manual worker between the ages of sixteen and sixty-four, or a non-manual worker earning not more than $1217 a year, is entitled in case of incapacity through sickness to draw $3.65 a week for a period not exceeding twenty-six weeks. For women workers, the benefits are $2.92 a week. The British system of health insurance now covers 16,400,000 workers, and involves a total expenditure of about $200,000,000 a year.

Most persons will consider it entirely fair and proper for the worker to contribute to the health insurance fund, but some may object to the employer being taxed for this purpose. In so far as the inability to work is caused by occupational disease, the employer can rightly be charged with being largely responsible for the loss of time, just as in the case of industrial injuries; but only a part, and probably a minor part, of the illness of workers is attributable to the neglect of employers to provide sanitary working conditions. If the employer's contribution to health insurance requires justification, it is doubtless best to place it on the ground of social expediency. Since the worker is to pay something, the most convenient and least expensive method of collection is to have the employer hold back a specified amount of his wages. But since the worker cannot afford to meet the whole expense, it is expedient from the social point of view to let the employer also make a contribution. In most instances at least, this contribution will enter into the costs of production, and therefore into the selling price. In this way the employer will usually find it possible to shift the burden of health insurance to the ultimate consumers of his product.

Health insurance, it may be said once more, must be *compulsory* if it is to benefit those who need it most. With workers interpreting too literally the Biblical precept, "Take no thought for the morrow," and with employers none too willing to assume social

responsibilities that involve money payments, it will not do to intrust so vital a measure as health insurance to the vagaries of voluntary acceptance. Its adoption, like that of workmen's compensation and other forms of social insurance, must be enforced by the state.

Old Age

For the worker who escapes or manages to survive unemployment, industrial injury, and loss of time through sickness, old age lies in wait at the end of the trail. How ill equipped the average worker is to cope with this last great bearer of economic insecurity may be judged by reference to the figures we have already given relating to average yearly wages and minimum yearly expenditures in the United States. The prospect of living to "a ripe old age" is not so alluring when it is realized that two out of every three persons who attain the age of sixty-five in this country are from that time forth dependent upon others for support.

The Extent of Old Age Dependency.—It is estimated by the federal Social Security Board that 6 per cent of the population of the United States, or 7,800,000 persons, are sixty-five years of age or over. The Board estimates, further, that 5,070,000 (or about two-thirds) of these persons are dependent upon public, private, or family aid. Nearly 70 per cent rely upon their children or other relatives for support, the others being cared for through private and public relief, in and out of institutions.[21]

"Old Age" in Middle Life.—In referring several times to persons sixty-five years of age and over, we have not meant to imply that this is necessarily the point at which "old age" sets in. The ability to render useful service is not restricted to youth and middle age. The old saying that "a man is as young as he feels" has in it much truth, for we can find plenty of examples of men who are young at seventy-five and others who are worn out at forty. Many persons are self-supporting long after they have reached sixty-five, but it is unquestionably true that as the years accumulate the average worker finds it increasingly difficult to secure and hold fast to a remunerative job.

The situation has become particularly acute of recent years, for there has developed, on the part of business enterprisers, a growing reluctance to take on new workers who are more than forty years

[21] *Ibid.*, April 24, 1938.

of age. Indeed, it is the policy of some concerns to limit the hiring age to thirty-five years in the case of unskilled labor. Our census figures show that in agriculture, in small businesses, in professions, and in public service, this discrimination against the older workers has not been exercised extensively, but in the great extractive and manufacturing industries the age limit has undoubtedly been declining steadily. "At the Highland Park Plant of the Ford Company," wrote Dr. Harry W. Laidler a few years ago, "about three-fourths of the men were found to be under forty. It is practically impossible for a man over forty to get a job there, while men who have reached that age find difficulty in holding their jobs. In a recent investigation in certain steel mills, it was found that the average age of the steel workers was not far from thirty."[22] The adoption of specific age limits is usually attributed to the lower wages of younger workers; their greater speed, endurance, and adaptability; the higher cost of group insurance when older workers are included; the adoption of non-contributory pension systems; and the cost of workmen's compensation.

Despite the present practice of turning workers loose at an age that used to be thought "the prime of life," the measures that have been taken to care for old age dependency seldom provide for payments before sixty-five in the case of men, and sixty in the case of women. These were found to be the usual ages of "retirement" in a study of industrial pensions conducted by the National Industrial Conference Board.[23] This means in reality that those able to hold their jobs until they attained the ages mentioned would then begin to draw pensions, other workers being dismissed in the meantime as they appeared to their employers to be liabilities rather than assets. The public pension systems thus far inaugurated in the United States stipulate that payments shall not begin before the age of sixty-five, and in some instances not until the dependent has reached seventy years of age. If industrial workers are to be "scrapped" at forty, forty-five, or fifty, a pension that does not provide payments before sixty-five is clearly deficient. Unless the present tendency to discriminate against the older workers is checked, it will be necessary to revise our working concept of "old age," and to define it as that age at which a worker

[22] Harry W. Laidler, *Unemployment and Its Remedies,* New York, League for Industrial Democracy, 1931, p. 20.

[23] *Elements of Industrial Pension Plans,* New York, National Industrial Conference Board, Inc., 1931, p. 20.

is no longer wanted by industry and is therefore unable to secure even reasonably steady employment.

Savings as Security Against Old Age.—It is hard to dislodge from the minds of successful business men the notion that whoever is industrious, sober, and thrifty can himself provide against the various forms of economic insecurity. "When business men think of security for their businesses against the day of misfortune, they think in terms of surpluses," said a former president of the National Association of Manufacturers in a public speech. "The building up of corporate surpluses . . . is generally recognized as not only a sound principle of business, but a saving principle, and I see no reason why it is not as applicable and essential to the economic program of an individual as to that of a corporation. I cannot conceive of security of enduring character apart from the practice of thrift and energetic exercise of individual responsibility."[24] This cheerful philosophy assumes that there are times in the life of every person when his income is greater than his necessary expenses; otherwise, he would experience considerable difficulty accumulating a surplus. But studies of wages and family budgets show the weakness of this fundamental assumption. If, as we have seen, the *average* wage in the United States is barely large enough to buy a minimum standard of living, it is idle to talk of setting aside surpluses to meet the emergencies of unemployment, accident, sickness, and old age.

We are not here suggesting that it is impossible for any wage earners to save. The two and a half million "thrift accounts" of the Postal Savings Systems, with an average deposit of $455, are evidence to the contrary. The unknown volume of workingmen's deposits in savings accounts is further proof that very modest surpluses can be, and are, built up, at least temporarily, by the more fortunate wage earners. But the futility of asking wage earners in general to guard against economic insecurity by adopting the corporation plan of accumulating surpluses "out of their earnings during the days of profitable operation," becomes apparent when we recall that one-third of the wage earners in the United States receive from $500 to $1000 a year each, while the incomes of another one-third fall between $1000 and $1500.

Trade Union and Industrial Pensions.—Trade unions and individual business concerns have done something to relieve old

[24] John E Edgerton, "Principles of Economic Security," in *Annals of the American Academy of Political and Social Science*, March, 1931, p. 76.

age dependency by arranging to pension their members and employees, respectively. According to officials of the American Federation of Labor, nine international unions and six local unions are paying $4,000,000 a year to about 11,500 pensioners. Figures from the United States Pauper Census indicate that 80,000 persons are receiving industrial pensions, with total payments estimated at from $50,000,000 to $60,000,000 annually. Through these two types of relief, therefore, about 90,000 dependents receive aid, amounting on the average to $350 a year for the trade unionists, and from $625 to $750 annually for the industrial pensioners.

Pensions for Public Employees.—A much larger number of old age dependents are taken care of under the pension systems that have been provided for certain employees of the federal, state, and municipal governments. Civil service employees of the United States government contribute 3½ per cent of their basic salaries to a pension fund from which, at the age of seventy, they draw annual benefits ranging from $180 to $1000. They are also protected against total disability prior to the age of retirement. Payments to the amount of approximately $440,000,000 a year are made to 300,000 federal civil service pensioners. Public school teachers form the largest group of state and municipal servants now enjoying retirement privileges, though pensions have also been provided by these governmental units for certain other classes of workers. It is estimated that fully 400,000 public school teachers come under the protection of state or municipal pension systems. Other pensioners in the field of public or semi-public service are veterans of wars previous to the World War, to whom payments are made by the United States government; college teachers, who come under the retirement provisions of the Carnegie Foundation, or the annuity system of the Teachers' Insurance and Annuity Association; and superannuated preachers and their dependents, who are provided for by the church boards of the several denominations.

The Case for Industrial Pensions.—The scattered data presented here are unsatisfactory in many respects, but they serve at least to show that federal, state, and municipal governments have recognized more fully than business enterprisers an obligation toward employees who are no longer capable of earning a living. This does not mean that employers are oblivious to the merits of

industrial pensions, or that they have done nothing toward putting pension plans into operation. We have noted the fact that 80,000 retired workers are now drawing industrial pensions; and it is estimated by Mr. A. D. Cloud, an authority on the subject, that probably 5,000,000 workers are covered by the 413 *formal* pension systems of the United States, besides those coming under the 300 or more *informal* plans. It seems probable, then, that some 20 per cent of all persons gainfully employed in industry are in some measure protected against old age dependency by the prospect of receiving pensions.[25] But the protection is not complete, since only 30 per cent of the pension systems are *contractual*, comprising definite obligations to the performance of which the employer is legally bound. In many cases, whatever "rights" the worker may have are those of a *pensioner* and not of an *employee*. Usually the employer attempts to word the agreement in such manner that he is unhampered in granting or denying a pension, the worker being uncertain whether he will receive any benefits from the system until he is actually placed on the pension list. However, as Mr. Cloud explains at length, the employer's "disclaimer" is often declared invalid in the event of litigation.[26]

There is no reason to suppose that many employers would fail to live up to the spirit of any pension system which they had voluntarily adopted. Indeed, the payment of pensions is coming to be regarded by our largest industries as a business proposition, and not an act of philanthropy. There has until recently been no legal obligation to adopt a pension system for superannuated workers, but the truth is that these aged workers have been recognized by enlightened concerns as "drags upon production," and many enterprisers have believed it too costly to keep them at their accustomed tasks. Of course they might have been discharged, but the thought of "firing" employees who have grown old in service is repugnant to most employers, and, moreover, this sort of practice tends to break the morale of those who remain. But in the case of pensioning, "every attendant circumstance is decent, ethical, and every resultant reaction potentially beneficial."[27] Many concrete advantages accrue to the employer who adopts a pension system, not the least of which is a reduction in labor turnover.

[25] Arthur D. Cloud, *Pensions in Modern Industry,* Chicago, Hawkins & Loomis, Co., 1930, chap. 7.

[26] *Ibid.,* pp. 131-134, 313-322.

[27] *Ibid.,* p. 50.

Indeed, Mr. Cloud believes that a pension plan *can* pay for itself by increasing the continuity of service.[28]

The Need for Compulsory Pensions.—Despite the benefits that a business enjoys through the operation of an industrial pension plan, the adoption or rejection of a pension system cannot safely be left to the individual enterpriser. In this, as in all types of social insurance, compulsion is an essential feature; for if the proposed measure for relief is put on a voluntary basis, there will inevitably be unprogressive employers who will ignore it completely. This lesson was long since learned by the nations of Europe, to whom social insurance of various kinds is now an old story. No important foreign country except Japan has voluntary old age insurance today; but there are at least twenty-five countries operating under compulsory systems, with pensions paid from general funds to which employers and employees, and sometimes the state as well, contribute.

Old Age Annuities Under the Social Security Act of 1935.—The Social Security Act provides for a system of annuities to be paid to people over sixty-five years of age who have aided in building up a fund by making periodic payments in their earlier years. This annuity plan consists of a contractual arrangement between the federal government and the worker who contributes to the fund. The annuity which the worker receives in his old age is his by right and not by grant. It is his regardless of whether he has or has not other sources of income; and it is his to spend, save, or give away, as he may choose.

This annuity scheme is a federal and not a state plan, and applies to all workers in certain trades throughout the United States. It is financed by taxes or contributions made by both employers and employees, dating from January 1, 1937. This annuity plan, like the unemployment insurance arrangement provided under the Social Security Act, does not apply to agricultural workers, domestic servants in private homes, officers and crews engaged in shipping in United States waters, and employees of non-profit-making organizations. Individual enterprisers, such as self-employed farmers, professional men and small shopkeepers, are not covered by the plan; nor are the 24,000,000 housewives or the millions of others who do not rate as "gainful workers." In 1938, the Chairman of the Social Security Board reported that 40,000,000 workers were covered under the old age annuity pro-

[28] *Ibid.*, p. 468.

visions of the Social Security Act. No annuities will be paid until 1942, five years from the time set by the Act for the first payments to the fund by employers and employees.

Both employers and employees are required, by the Act, to contribute to the annuity fund 1 per cent of total wages paid or received from 1937 to 1939 inclusive, 1½ per cent from 1940 to 1942, 2 per cent from 1943 to 1945, 2½ per cent from 1946 to 1947, and 3 per cent in 1948 and thereafter. It is estimated that by 1980 the plan will be paying for itself, and in the meantime the receipts will be considerably greater than the disbursements, so that the Old-Age Reserve Account, as it is called, will be growing steadily.

The amounts received by the workers will vary from $10 to $85 a month, depending upon the size of their individual contributions to the fund and the period of time during which they have made payments. The monthly payment is calculated on the basis of one-half of 1 per cent of the first $3000, one-twelfth of 1 per cent of the next $42,000, and one-twenty-fourth of 1 per cent of the next $3000. For an annuitant who has drawn a wage of $100 a month over a working life of forty years, the monthly income after sixty-five is $51.25; and this income continues, of course, as long as he lives. For a generation, however, the annuities will be smaller because the annuitants will have made their contributions to the fund over a shorter period of time. As in the case of unemployment insurance, the payments made to the Old-Age Reserve Account by both employers and employees will doubtless be shifted, in large part, to the ultimate consumer, appearing in the form of higher prices.

The federal annuity plan is regarded by social workers in general as a move in the right direction. Its shortcomings, which have been recognized by both advocates and opponents of social security, will doubtless be remedied by amendment.

State Old Age Pensions.—A system of compulsory industrial annuities relieves many of our workers of the fear of a wholly penniless old age. It leaves largely unprotected, however, those workers who have been unable, even with their employers' help, to build up a retirement fund of appreciable size; and overlooks entirely, as we have already seen, the workers in many occupations whose daily tasks do not bring them under the provisions of the Social Security Act. Such persons are entitled to support in their declining years, as we have acknowledged through the

maintenance of almshouses or poorhouses, which now, happily, are giving way to more humane and less costly methods of caring for the aged.

For a good many years, about a dozen of our states have been providing old age pensions for their citizens. These payments were not annuities, such as we have described in the preceding section, but allowances for old persons with no other source of income. In general, the age at which payments began has been sixty-five to seventy; the *maximum* allowances of the several states have run from $250 to $365 a year; and there have been residence requirements ranging from one to fifteen years of residence in the country, and from ten to fifteen years in the state.

In an attempt to extend old age pensions to the destitute aged throughout the country, the framers of the Social Security Act of 1935 included in its provisions the payment by the federal government of one-half of payments made by any state to its needy aged, up to the total of $30 a month, or a maximum contribution of $15 a month by the federal government for a single pension. This means at least some assistance to the indigent aged in the states which accept the terms offered by this section of the Act, and all of the states but one have already done so. However, the needy do not always receive as much as $30 a month, since some states have decided upon smaller pensions. Indeed, the average monthly grant amounts to only $19.26.[29]

These payments are clearly in the nature of charity, being paid avowedly to destitute persons only, who are required to prove that they have no other source of income. This seems to us to be a disadvantage. We believe that federal provision should be made for either an annuity or an old age allowance for every person of sixty-five years or over, whose total income from other sources does not exceed a stated amount, say $400 a year. We propose, in other words, that everyone in the country shall enjoy the protection of a guaranteed old age income. The aged person would collect, then, from the annuity plan to which he has contributed, or from the old age allowance plan, but not from both. Presumably the annuity payments would be considerably larger than those paid from the public treasury, so that the choice would be an easy one to make. But the public provision for those without annuity provision should be of such size as to insure at least a minimum of comfortable subsistence, and should vary with changes in the

[29] *New York Times*, August 7, 1938.

price level. We believe that dependence upon old age provision of this kind should not involve a loss of self-respect on the part of the recipients, and we see no reason for any greater stigma attaching to the acceptance of an industrial annuity or public allowance than now attaches to the acceptance of free public school training or police protection.

We referred, a little while back, to the costliness of caring for dependents in almshouses and similar institutions. Old age pensions are more economical, largely because the operation of poorhouses entails very high costs of administration, sometimes amounting to more than 50 per cent of the total appropriations for these institutions. After eight months' experience with old age pensions in Pennsylvania, the commission in charge reported that the total cost of the pension system in that state would not exceed $5,000,000, and added that for that sum "we would be able to take care of more than three times the number of people now supported in our almshouses, upon which institutions we are now making an annual cash expenditure of approximately $6,000,000."[30] Through the adoption of a comprehensive system of old age pensions, we have the opportunity not only to repay a debt, long since overdue, to the aged men and women whose labors have swelled the incomes of the well-to-do, but also to handle humanely and economically a problem which is now being dealt with in a barbarous and wasteful fashion.

Conclusion.—The limitations of space have made it impossible for us to give to the problem of economic insecurity the thorough examination which, by virtue of its social consequences, it deserves. We have looked into the matter sufficiently, however, to understand that the problem consists of maladjustments over which the worker has no control—maladjustments which, nevertheless, cut off his income and thus deprive him of purchasing power that he must somehow secure if he and his dependents are to have the necessities of life.

We have proposed that whatever aid is required shall be provided, either directly or indirectly, by the community of which the worker is a member. In this country, the "community" will in some cases be the state and in other cases the nation. The means by which aid may best be rendered appears to be social insurance of appropriate types. We believe that premiums covering insur-

[30] Quoted in George B. Galloway, *Public Old-Age Pensions,* Washington, D. C., Editorial Research Reports, 1930, vol. 3, No. 8, p. 591.

ance for unemployment, industrial accidents, sickness, and old age are legitimate costs of production, in so far as these forms of maladjustment are unavoidable. The consuming public should expect to pay, and be willing to pay, prices that include these necessary costs; and it is inevitable that, in the long run, irreducible costs for social insurance will enter into the selling price of any product into the manufacture of which labor protected by compulsory social insurance has entered. Consequently, such insurance will not, in a given industry, impose a burden upon those concerns which succeed in reducing unemployment to a minimum, safeguarding their employees against accidents and sickness, and so conserving the strength and skill of their workers as to make it unnecessary to pension employees until they have reached an advanced age. It is only those firms that fail to duplicate the performance of such socially minded concerns, that, by reason of high insurance premiums, will be forced to bear any part of the burden of social insurance; and, as we have suggested, this penalty of high costs will provide the incentive to lessen the maladjustments that give rise to these high costs.

It is probable that there will always be some members of society who, because of physical or mental defects, cannot be expected to support themselves. Unfortunates of these kinds will have to be cared for at the public expense, unless they have friends or relatives who are able to look after them adequately. But as for the great mass of industrial workers who are anxious to be self-supporting, we believe that, in general, it is both fair and feasible that the industries with which the workers ally themselves should be made responsible for providing economic security. Once a worker has attached himself to an industry, this industry should be made to contribute to a fund from which he will receive an income when he is not working, just so long as his idleness is not voluntary. In times of unemployment, he should receive unemployment benefits; if incapacitated by accident or sickness, he should have "compensation" or "sick pay"; and when, by reason of the infirmities of old age, he is no longer able to perform his daily tasks, he should have either an annuity or old age assistance provided by the state.

Ordinarily, the cost of industrial security may properly be levied against the industry that is involved, but in certain instances, as we have already suggested, it may be better for the state or federal government to make the payments directly to those

entitled to them, from funds collected through steeply graduated taxation. In either case, we believe firmly that the community should definitely accept the responsibility for providing, directly or indirectly, a substantial income to all members of society who are willing to work but who, because of circumstances wholly beyond their control, are unable to command the purchasing power needed to buy the necessities of life.

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1. It is said that confusion in the use of the words "accident" and "injury" leads us to give less attention to *accidents of all kinds* than they deserve. Explain.
2. Distinguish carefully between "direct" and "indirect" costs of injuries, and give some idea of the relative monetary significance of the two.
3. It has long been believed that most industrial injuries are caused by the failure to provide safe physical conditions of work. Argue that this belief is or is not sound.
4. How might the cause of accident prevention be advanced through modifications of the benefits paid to injured workmen under the provisions of the workmen's compensation laws?
5. "It would pay society in dollars and cents to provide free medical and hospital service for all who need it, and to require employers to pay sick benefits to ailing workers." Examine critically the facts upon which this statement is based, and decide whether they are or are not adequate. In other words, determine whether the above conclusion is warranted by the facts that are presented.
6. What is the attitude of the medical profession in general toward socialized medicine?
7. "Sickness benefits should and must be paid to ailing workers." Argue pro and con.
8. What relationship, if any, do you see between *"old age" in middle life* and *technological unemployment*?
9. To what extent does dependent old age exist in the United States at the present time, and what measures have been taken to care for the destitute?
10. Discuss the possibility of handling the problem of old age maintenance by means of savings accumulated during working years.
11. The champions of social insurance usually insist that it must be of the *compulsory* and not of the *voluntary* type. What grounds are there for believing that voluntary social insurance does not meet the needs of the situation?
12. Summarize the old age provisions of the Social Security Act of 1935.

13. "Too much is being expected of government. Louder and louder the voice of the demagogue is sounding through our land, and bolder are becoming the forces of resistance to orderly procedure. The number of those who openly confess their communistic dreams is still relatively small, even though it has been growing in this season of discontent. . . . From such conditions and sources there naturally come, and will probably continue to come until the conditions have passed, proposals for public unemployment insurance and other schemes in the name of charity to subtract from private responsibility and add to that of the government."

    In the light of this statement, criticize the proposals for social security that were made in the present chapter.
14. Unemployment, industrial injury, sickness, and old age have been dealt with as phases of the general problem of economic insecurity. What have these four items in common that makes it possible to consider them as parts of the one broad problem?

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5 WAGES AND POPULATION

IN A SOCIETY IN WHICH PRACTICALLY ALL COMMODITIES AND SERVICES ARE "ECONOMIC GOODS" AND NOT "FREE GOODS," THE question of purchasing power is of paramount importance. Between riches and poverty there is a great gulf fixed—the rich have an abundance of purchasing power, the poor virtually none. Those who have great purchasing power may, like Dives, fare sumptuously every day, but those who have none get only the crumbs that fall from the rich man's table. The purchasing power received by industrial workers comes almost wholly in the form of wages. It is largely on this account that labor seeks always to raise wages, and clings tenaciously to wage levels already attained whenever reductions are threatened. For the laborer is no less anxious than the business enterpriser to have what he considers the "good things" of life.

Real, Annual Wages.—Money wages consist of the money payments made to laborers in return for their contribution to production; real wages are the economic goods that workers secure when they spend their money wages. We shall think of wages as including all incomes from personal services, whether the services are those of the day laborer or the highly paid manager; and we shall confine our discussion to *real wages*, since our primary interest in the present chapter is in the purchasing power that workers receive in exchange for their services. When we examine the problem of price levels,[1] we shall see that purchasing power varies from time to time, so that a given money wage may mean twice as much purchasing power in some years as in others. Hence, the necessity of talking of real wages, or money wages in relation to the existing price level. The wages that are important, moreover, are those that represent an *annual income* from personal services, and not wages per hour, day, week, or month. This is true because, as we noted in Chapter 3, many wage earners are not able to find steady employment, and yet their annual earnings

[1] In chap. 9.

must provide whatever economic goods they and their families are to enjoy throughout the year.

The Relation of Population to Wages.—One of the most serious problems of labor is the prevalence of low wages among many classes of workers. Wages are paid for the use of labor, as a price is paid for any commodity, on the basis of scarcity. If, then, wages are low, they are low because labor is relatively plentiful. This fact suggests the possibility of regulating wages by affecting the supply of labor through the control of population growth. It is this relationship between population and wages that leads to the problem of low wages, which we shall examine in the present chapter.

National Wage Levels and Population.—A survey of wages throughout the world indicates that real wages vary considerably from country to country. Workers in the United States enjoy the highest real wages to be had anywhere at the present time. Average real wages in England are slightly less than two-thirds as high, in Germany about one-third as high, and in Italy one-fourth as high as in this country. The limited quantity of comparative data that are available indicate that a member of a given class of workers, say a carpenter or a teacher, receives more economic goods in exchange for his services in the United States than in England, Germany, or Italy.

We need not suppose that it is unusual skill or industry on the part of the American workers that accounts for the superior wages that they receive. It is undoubtedly true that many workers in this country are receiving much higher real wages than equally industrious and skillful craftsmen in England and Germany. The explanation lies chiefly in the relationship between numbers of workers in this country and the quantity and quality of the other productive agents with which they must be combined in order to turn out economic goods. In general, when there is a great abundance of land and capital that can be combined with each available unit of labor, wages will be high; when labor is plentiful, and land and capital are relatively scarce, wages will be low. The workers in the United States have the good fortune to be combined, in their productive undertakings, with large quantities of excellent land and capital, so that not only the national income, but individual incomes as well, are larger than in less favored countries. Given two countries, one with large national income and the other with small, but both countries having the same sys-

tem of distribution and number of workers, the wages in various occupations will be higher in the first country than in the second.

Per Capita Income.—In Chapter 2, we touched upon the desirability of a country having a large total product, since it is from the total product that the owners of the productive agents must receive their pay. By a *large* product, we mean, of course, one which, when divided among those who are to share in its distribution, provides large per capita incomes. The national income of the United States in "good times" such as prevailed in 1929 is roughly $90,000,000,000, or about $750 per capita. If, with this national income, our population were only 90,000,000, instead of 120,000,000, obviously we should be better off economically since we would then have a per capita income of $1000. If, on the other hand, our population should rise to 180,000,000, with no increase in national product, the per capita income would drop, of course, to $500. It is scarcely necessary to say that a per capita income of $750 does not mean that every man, woman, and child in the United States actually receives this amount annually. Owing to the concentration of wealth and our method of distributing income, a relatively small number of Americans receive extremely large incomes, while the vast majority have only enough to buy a satisfactory standard of living, and many are definitely poverty-stricken.

No country, then, can provide prosperity for its people if the population is so great or its national income so meager that its per capita income is small. Even a very large per capita income, as we have just noted, is no guaranty of *general* economic welfare, since per capita income is merely an average, in which may be concealed dizzy heights of individual prosperity and abysmal depths of individual poverty. In every capitalistic country we find wide differences in individual wages for personal services; in the United States, for example, wages range all the way from the thousand dollars or less a year received by pick-and-shovel men to the half million dollars or so paid to motion picture stars or banking experts. These wage differences are, again, related to numbers. The number of day laborers is large in relation to the demand for their services, and as a consequence their wage is low; the number of capable actors and expert bankers is small in comparison with demand, and they are able on that account to command high wages. We shall do well to look more closely into the principle of wage determination.

Productivity, the Demand for Labor, and Wages

General and Individual Wages.—A statement to the effect that the general level of prices is high or low tells us nothing about a specific individual price that enters into the calculation of the price index number. In like manner, the existence of a high or low level of real wages within a country does not indicate how persons engaged in particular lines of work are faring. This is the point that we tried to make in our discussion of per capita incomes, and which we shall pursue somewhat further as we examine the principle of wage determination. Just as we are more often interested in the price of a specified grade of bread, calico, or coal, than in general commodity prices, so when it comes to wages we pay more attention to the earning capacity of bankers, weavers, or miners than to per capita incomes. It is on his own wages, and not on per capita income, that the worker and his family must live. It is individual real wages, therefore—the wages that they themselves receive—about which the workers are concerned; and these are the wages they have in mind when they insist on wage increases or resist wage cuts.

The Demand for Labor.—Individual wages, like individual prices, are determined by the conditions of supply and demand. For every type and grade of labor there is a demand schedule; that is to say, there is a series of quantities of this labor that will, at any given time, be utilized by business enterprisers at a corresponding series of prices (or wages). In accordance with the Law of Demand, the lower the wages at which workers can be had, the more labor will enterprisers be willing to buy. Thus a demand schedule for farm labor might indicate that, in a given market at a given time, the employer-farmers would hire 5000 laborers at the wage of $1.50 per day, 4500 at $1.75, or 4000 at $2.00. We may assume, as most modern economists do, that the marginal productivity of farm laborers prevents these employers from paying more than the wages stated above for the various quantities of labor listed in the demand schedule, and that competition for the services of these workers prevents their paying less. Clearly, then, the wage will be affected powerfully by the quantity of labor that is available in this market. If there are only 4000 laborers seeking jobs, each can command a wage of $2.00 a day; but if the number is 5000 they will have to get along on $1.50 a day per worker, since this is the maximum that they

can hope for under our assumed conditions of demand, if all are to be hired.

The Influence of Marginal Productivity upon Wages.—It is not essential to our present inquiry to examine in detail the factors that affect the demand for labor,[2] but we may describe very briefly the concept of "marginal productivity," which was mentioned in the preceding paragraph. If, when 4000 laborers of a given grade are employed, the withdrawal of one worker for one day would entail a loss of $2.00 worth of total product, any one of the 4000 laborers is said to be a "marginal worker" and the value of the product that would be lost if he quit work is called the "marginal productivity" of labor of this kind. Since the loss of any worker for a day means the loss of $2.00 worth of product, employers can afford to pay such a worker anything up to this amount (that is, any amount not greater than his marginal productivity), and if competition is perfect the bids of the various enterprisers who wish to hire labor of this kind will force the wage up to approximately this figure. Wages, therefore, tend ordinarily to equal the marginal productivity of labor.

But, because of the workings of the Law of Diminishing Productivity, the marginal productivity of labor declines after a certain point has been reached in its utilization. If, then, 5000 farm hands, instead of 4000, are employed in combination with a given quantity of land and capital, the marginal productivity of labor will inevitably be smaller than before. Our hypothetical demand schedule suggests that with 5000 laborers available the marginal productivity of labor will be $1.50 a day. If this is true (and it will be true under strictly competitive conditions), the wages of farm hands must likewise be $1.50 a day.

The Significance of "Proportionality."—It should be noted that a daily wage of $2.00 for each of 4000 farm laborers, and of only $1.50 for each of 5000, does not mean that the 5000 work any less skillfully or less diligently than the 4000. We are justified in assuming that every man of the 5000 hoes just as many rows or plows just as many acres as every one of the 4000 hands. And yet, for some mysterious reason, the same expenditure of brain and brawn brings the worker a wage of $2.00 a day when there are 4000 of his kind available, but only $1.50 when he is one of a goodly company of 5000. To some persons, and particularly

[2] The theory of wage determination is treated more fully in Paul F. Gemmill, *Fundamentals of Economics*.

to labor itself, it appears distinctly "unfair" that workers, though turning out the same quantity and quality of product, and therefore exerting the same amount of effort, should yet command a smaller wage at one time than at another, simply because of a change in circumstances wholly beyond their control.

The explanation is that workers are not paid in proportion to their expenditure of effort. The thing that business enterprisers are interested in, so far as labor is concerned, and the only item for which they pay wages, is the *exchange value* of the product that is attributable to the worker's efforts. The prices that enterprisers stand ready to pay for various quantities of labor depend upon their estimates of the additions that further units of labor of the type in question will make to the total sales value of their respective products. More units of physical product can be made with the help of 5000 workers than with that of 4000, but we know, from the Law of Demand, that this larger quantity of product can be disposed of only if the price per unit is lowered. The total receipts from the enlarged product will not be sufficient, therefore, to permit enterprisers to pay wage earners as liberally as though a smaller product were turned out with the assistance of 4000 laborers. We are assuming, of course, that the demand schedule is the same in both instances, that the supply of land and capital remains unchanged, and that the point of diminishing productivity has been passed.

Whether the wage of a particular type and grade of labor is high or low depends, then, upon whether this kind of labor is or is not plentiful in relation to the quantity of land and capital that is to be used in combination with it. When labor is very abundant, one worker more or less is of little importance because his productivity is slight, and consequently he receives only a small wage; but when labor is very scarce every worker adds materially to the productivity of the industrial process, and on this account can command high wages. Business men are striving continually to combine the factors of production in the most advantageous proportions. If production is limited by a shortage of land and capital, enterprisers will bid high prices for the use of these productive agents, and rent and interest rates will rise. If labor happens to be the limiting factor, the competition among business men to secure this agent of production will bring high wages to workers.

Anything that has the effect of making labor relatively unim-

portant will have the effect, also, of reducing wages. The introduction of the free public school system in America increased the number of clerical workers so greatly that the wages of labor of this kind slumped appreciably. More recently, the invention of the Owens bottle-making machine so reduced the economic importance of glass-blowers that they voluntarily accepted a 20-per cent wage reduction in 1909, and a similar cut in 1912, to avoid being laid off completely and permanently. In both of these instances the supply of labor was so abundant, in relation to the need for such labor, that it was impossible to maintain the previous wages.

Population, the Supply of Labor, and Wages

The "Optimum Population."—Labor is human energy expended for the purpose of acquiring income. It is definitely tied up, therefore, with the existence of human beings, and the quantity of labor is dependent chiefly upon the size of the population. The labor supply is affected, also, by the proportion of the population that is gainfully employed, the amount of time that the workers give to productive effort, and the intensity with which they work; but these are matters which, for considerable periods of time, are fixed by custom or even by trade union regulation. The amount of time expended in work and the intensity of effort being what they are, we may generalize to the extent of saying that a large population means a large quantity of labor available for use in productive enterprise. Whether the population is of a desirable size economically depends upon whether the land and capital with which the "gainfully employed" are set to work are adequate in both quantity and quality. From the economic point of view, the best or *optimum* population is that which results in the production of the greatest per capita output. It is large output per unit of population, and not per unit of land or capital, that makes for human welfare. Some of the the most productive land in the world is that which is cultivated very intensively by the people of China and India. But so much labor is lavished upon its cultivation that the product, though large per unit of land, is so small per unit of labor that those who farm it are seldom free from the threat of starvation. Since the goal of production is to provide human beings with commodities and services, production is (from the social point of view) most successfully carried on

when per capita income is at its maximum, if only this income be distributed in a socially desirable way.

Labor of Specific Kinds.—But we must consider specific kinds of labor, and not labor in general, if we are to understand the relationship between population and the supply of labor. It is obvious that wages in a given trade, say in plumbing, are not affected by the quantity of labor in general, but only, on the side of supply, by the number of plumbers in the market. Common laborers do not compete with plumbers, plumbers with architects, or architects with lawyers, in seeking remunerative employment. It is the number of plumbers available, in relation to the demand for their services, that fixes wages in the plumbing trade. If plumbers are relatively plentiful, their eagerness to get jobs will lead them to bid against one another, and wages will be pulled down; if, on the other hand, plumbers are relatively scarce, the competitive bids for their services will have the effect of raising their wages.

Since labor is a perishable commodity which goes to waste unless it is used day by day, and since in most wage groups the workers cannot afford to indulge in the luxury of voluntary idleness, the amount of labor of a given kind that is offered for sale at any given time is ordinarily the total quantity in existence in the market in question. There are occasional exceptions, of course, as in the case of strikes, but it is safe to say that there is seldom much labor withheld from the market. This being true, the owner of labor (who is the worker himself) is frequently in the uncomfortable position of the owner of a perishable material commodity, such as strawberries or fresh fish—that is, he is obliged to take whatever he can get for his wares, for if in the absence of high bids he refuses to sell at a low price, his commodity perishes and he gets nothing at all for it.

Shifting Labor from Market to Market.—If, over a considerable length of time, workers in a certain trade find it impossible to command a satisfactory wage, we might suppose that they would realize that their line of work was overcrowded and move off promptly to more lucrative fields. But this is more easily said than done. At the present moment our bituminous coal mines are notoriously overmanned. If some of these laborers should give up mining and go into less crowded industries, this action would not only bring higher wages to those who moved but would relieve the situation for those who remained, and thus be beneficial to

both. But where shall these mine laborers go in search of larger opportunities—where are the less crowded industries to which they could move? Here, indeed, is the crux of the problem, for it is difficult, if not impossible, to shift them about so that their lot will be improved. They might conceivably, with some slight training, become farm laborers, but there is already an abundance of such workers, as is indicated by their low wages. The same is true of common labor in the steel industry, in construction work, and so on.

The truth of the matter is that common labor is so plentiful throughout industry in general that there is little to be gained by moving workers of this kind from place to place. The most that could be accomplished by this procedure would be to bring about an equalization of wages among common laborers throughout industry as a whole, and the process of equalization has been going on for so many years that it can probably be carried but little further. Moreover, any gain that some of the laborers made would be at the expense of others; a movement of laborers from mines to farms, for example, would pull down the wages of farm hands by increasing their numbers and thus changing the proportions of land, labor, and capital to the disadvantage of labor. Whatever might be done in the way of shifting common labor would result, therefore, in equalizing wages among the workers of this group; and any wage changes that might be made in this way would doubtless be very slight. It should be noted that changes that did occur would be the result of changing the supply of labor of this kind in the several markets affected, reducing it slightly at one point only to increase it at another.

Non-competing Groups.—But why should not workers, if they are dissatisfied with their present wages, change over to new occupations that are better paid? The answer is that a limited number of the more ambitious or more fortunate do manage to work their way from poorly paid jobs into positions that command high wages, but to the great majority the obstacles to such progress appear to be insuperable. The day laborer at $4 a day would like to be a carpenter at $10, but cannot afford to serve the long apprenticeship without which one is not permitted to follow carpentering. The chorus girl at $50 envies the prima donna her two thousand a week, but has neither the voice nor the personality demanded of a musical comedy star. The grade school teacher at two thousand a year would like to be a high school

principal at five thousand, but lacks the education and executive ability essential for holding this position. As a consequence of lack of ability or lack of opportunity—and quite often the latter—there is surprisingly little competition for well-paid jobs on the part of those who are poorly paid.

Because of the tendency for workers to "stay put," once they get into a particular wage class, economists sometimes distinguish among certain broad divisions of wage earners, to which the name "non-competing groups" has been given. Though the classifications made by writers differ considerably, the following list will serve as well as any to show that there is not a free movement of labor from grade to grade:

1. *Common Manual Laborers.* These are our hewers of wood, drawers of water, diggers of ditches, and other workers whose contribution to production lies chiefly in the expenditure of physical strength. They need no special training, and assume no responsibility in their daily work other than doing what they are told to do. Their annual wages, though always low, are highest in early life when they are strongest and most vigorous, and fall off rapidly after middle life is passed.
2. *Semi-skilled Workers.* Here are found factory workers whose duties consist of tending semi-automatic machines, and also clerical workers filling routine jobs. In this group, moreover, belong such workers as taxicab drivers, whose duties demand an alert mind and the assumption of some responsibility. Sales people of ordinary ability may be included among the semi-skilled. The pay in this group of workers may be slightly higher than that of common labor, or it may at times be lower. But in either case, since the worker does not depend primarily upon physical strength for the performance of his task, he is able to carry on his work at a more advanced age than those in Group No. 1.
3. *Skilled Workers.* Both native ability and training play a part in this field of activity. Here we find machinists, plumbers, electricians, carpenters, and other skilled craftsmen; expert stenographers, bookkeepers, and other high-grade clerical workers; teachers in the elementary schools; and other types of workers whose tasks require some training and the assumption of considerable responsibility.

The corner grocer, the barber, the owner of a shoe repair shop, and others who conduct small independent businesses may be included. Workers in this class ordinarily command comfortable, but not high, incomes.

4. *Professional Men and Business Managers.* Members of this group, in general, have incomes sufficiently large to buy high standards of living. Here are found physicians, lawyers, accountants, and technical experts of many kinds whose success hinges usually upon the possession of considerable native ability, and professional training covering a period of years. High-grade salesmen, such as those who deal in insurance and securities, may well be included. Here, also, belong many of our business executives.
5. *"Captains of Industry."* This term is used in this connection to designate those who are outstanding figures in the economic world, and who, by reason of their unique abilities—that is, because of the absence of much competition—are able to command phenomenally high wages. In this class are the organizers and directors of "big business," our "wizards of finance," and business managers who are more than ordinarily successful. Here, moreover, because of their extraordinarily large wages, belong some of our famous stars of the stage and screen, champion pugilists, and an occasional lawyer, playwright, and novelist.

It is important to note that not only do the incomes in these several groups range from very low wages in Group No. 1 to astoundingly high wages in Group No. 5, but the incomes vary *inversely* with the numbers of workers in the groups. That is to say, the members of Group No. 1, the largest of the five classes, receive the smallest individual wages, while those in Group No. 5, the smallest group in the list, enjoy by far the largest individual wages. The situation is frequently illustrated by use of a pyramid, as in Fig. 1, the size of the section given to each group indicating roughly the abundance or scarcity of workers in the group, and its height from the base line the position which its members occupy in the wage scale. This inverse relationship is not to be thought of as a mere coincidence. All that we know of wage determination leads to the conclusion that it is distinctly a *causal* relationship. Wages are low in Group No. 1 *because* there are so many workers in relation to the number of jobs available for

them; wages are high in Group No. 5 *because* its members are few in comparison with the demand for their services.

The existence of non-competing groups is believed to explain many of the differences in wages that may be observed on every hand. If all workers were alike, these differences in wages would promptly be wiped out by the force of competition. If any differences remained, and wages in some occupations were higher than in others, the extra pay would be merely compensation for the unpleasantness or riskiness of certain lines of work, and not the result of scarcity. But workers are not alike. They differ in

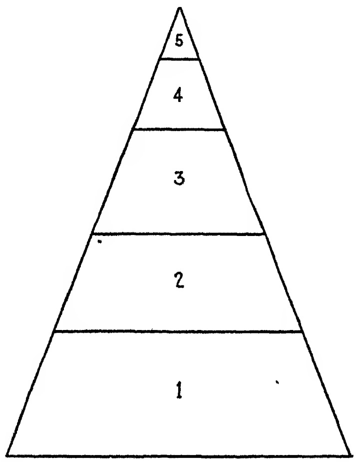

FIG. 1.—NON-COMPETING WAGE GROUPS.

native ability and training, as we have already said, and their differences prevent any considerable amount of competition between groups. It requires no argument to show that common manual laborers do not compete with great financiers. It is less clear, perhaps, that members of Group No. 1 are unlikely to bid for jobs wanted by those in Group No. 2; but in the main there is little competition between any two of the five groups. Occasionally, manual laborers may wander from Group No. 1, and, getting into Group No. 2 and being capable of doing semi-skilled work, bid against members of the second group, and thus bring down wages slightly; and semi-skilled workers from Group No. 2, having pursued a course of training, may elevate themselves into Group No. 3 and offer some competition to skilled workers there. But though this sort of thing may take place occasionally, it is safe

to say that there is but little movement of workers from group to group. The difficulties to be overcome in climbing into a higher class are too great for any save the exceptional man.

Permanent Stratification of Groups.—Moreover, there is a tendency for non-competing groups to be self-perpetuating. It would seem that parents, knowing from experience the inconvenience that goes with small incomes, would seek to get their children into the higher wage groups; or that the children themselves, trained in the stern school of poverty, would strike out for occupations more gainful than those in which their parents served. But the odds, alas! are heavily against any such advancement, so far as most workers are concerned. It is possible, indeed, but not probable, that a boy will rise from his father's wage class into one paying a larger income. The difficulties may be those of heredity or environment, or both. We cannot be sure that the son will start life with greater native endowments than his father. But even if he does, there is the troublesome problem of securing training for the higher grade of work. He may, it is true, enjoy greater educational advantages than his father has had; but then, again, he may not.

What one does in the way of securing an education depends, probably more often than not, upon the environment in which one is situated. Environmental influences are scarcely calculated, in the low-wage groups, to spur one on to great deeds. The son of a manual laborer, even though he has in him the making of a skilled electrician, a great lawyer, or a merchant prince, is unlikely to receive encouragement from his immediate family and associates, to set forth upon one of these careers. Indeed, it is probable that he will never learn of his inborn capacity for greater economic achievement; that he will, on the contrary, promptly get used to the standard of living of his father's wage class, and that, when he reaches man's estate, he will accept a job at "good wages" and continue to hold this job, or a similar one, throughout his working life. There is no way of knowing how much human talent goes to waste from lack of discovery or development, but there can be little doubt that the losses of this kind are enormous.

These are some of the hindrances to a free movement between the various wage groups that provide economic society with the productive agent that we call labor. Because there is no competition worth mentioning between these groups (though there may be a good deal of rivalry for jobs within a given group), wages

may be high in one group and low in another, as we have already suggested. Whether they are high or low will depend upon the supply of and demand for labor of the various kinds. High wages are based on the scarcity of labor, and low wages on its abundance. For example, the success of members of Groups No. 4 and No. 5 in securing high incomes is due primarily to the limitation of numbers in these fortunate groups. If captains of industry were plentiful instead of scarce, they would receive much lower wages than at present; but, as we have just explained, they are free from competition of workers outside their own group. So long as these various groups are separated one from another, with little opportunity for workers to move from group to group, we shall continue to have wage classes.

"Proportionality" Once More.—We see, therefore, that the quantity of labor is vastly important in the determination of wages. Low wages are the result of what is, for the workers, an unfortunate relationship in the quantities of land, labor, and capital. If labor should be reduced in quantity, land and capital remaining unchanged, or if land and capital should be made more plentiful without a corresponding increase in the quantity of labor, labor would become relatively more important and could claim and secure for itself a larger share of the product—that is, a larger wage. Practically all that has been said up to this point has been intended to emphasize the fact that wages are governed by the relationship between the quantity of labor, on the one hand, and the quantity of land and capital, on the other. If, then, low wages are to be raised, the remedy lies in making labor scarce or land and capital more plentiful. Since the workers can do but little in the way of bringing more land and capital into productive use, they might do well to concentrate upon the control of labor, with the thought of reducing the quantity available for productive enterprise, thus increasing the marginal productivity of labor and the price that is paid for its use. The quantity of labor may be controlled by regulating the birth rate or immigration, or both; and to a consideration of these methods of control we now turn our attention.

Wages and the Birth Rate

Population and Subsistence.—"Populations tend to increase as aggregate wealth increases and tend to decline in numbers as standards of living rise," says the author of an important work

on the theory of population.[3] The first half of this statement has long been understood, but the second is a development of modern times. Adam Smith, and even earlier English writers on economics, regarded a large population as the sign of a nation's material greatness, since they believed that the population of a nation was bound to expand with every growth in productive capacity. "The most decisive mark of the prosperity of any country is the increase in the number of inhabitants," wrote Adam Smith in his *Wealth of Nations* in 1776; and further, "Every species of animals naturally multiplies in proportion to the means of their subsistence and no species can ever multiply beyond it."

We have here the central idea of the Subsistence Theory of Wages, which for a time enjoyed wide popularity among economists. This theory recognized the fact that labor could be had only if provision were made for the maintenance of the laborers. This meant that the workers must receive, in exchange for their labor, a certain minimum of food, clothing, and shelter, in order to keep them alive and in condition to work. It was held, then, that wages tended to be fixed at that figure which would provide the worker with a bare subsistence for himself and his family. It was supposed that if wages were to rise so that they were more than adequate for maintenance at this very low level, the natural tendency for human beings to be fruitful and multiply would cause the worker to have more and more children. In this way, whatever gains might be made in wages would always be wiped out by the increased costs of supporting a large family, and the standard of living—that of bare subsistence—would remain unchanged.

Population and Rising Standards of Living.—From past experience, we have every reason to believe that populations do tend to increase as wealth increases, but not always at so rapid a pace. From 1800 to 1900, a period in which improved methods of agriculture and manufacture were flooding the world with commodities of all kinds, the population of Europe rose from 175,000,000 to 390,000,000. But this growth, great as it was, was not sufficient to keep up with the increased production of goods; and as a consequence the nineteenth century witnessed great improvements in the standards of living of the masses of workers. It is not inevitable, therefore, as the older economists believed, that wages should be held down to a subsistence level. Whenever

[3] Ezra Bowen, *An Hypothesis of Population Growth,* New York, Columbia University Press, 1931, p. 14.

increases in production outstrip increases in population, the per capita income rises and there is at least a possibility that the working classes will be able to command higher real wages than before. If every section of an economic society has shared in the population increase, and in exact proportion to its previous numbers, the larger total income resulting from improved production should provide higher real incomes for all. Of course, it would be still better, so far as standards of living are concerned, to have an increase in production while the population remained stationary. "If there had been no increase in population during the last one hundred and fifty years," says Professor Ely, "the marginal productivity of labor would (if, nevertheless, modern methods of production had been developed) have been much higher than it is, and wages would have been correspondingly higher than they are."[4]

A little observation shows quite conclusively that many parents refuse to have families of such size as will hold them down to a subsistence standard of living. It can scarcely be regarded as pure chance that the families of the well-to-do are usually small while those of the poor are usually large. Populations "tend to decline in numbers as standards of living rise," and there is today every indication that numbers are deliberately held down in order that high standards of living may be enjoyed. There is a limit to the number of children that can be well fed, well clothed, well housed, and well educated on a given income. An understanding of this fact, and a belief in quality rather than quantity, appear to be the only rational explanations of the small size of present-day families in the middle and upper classes. Population growth is governed by birth rates and death rates. The spread of sanitation and developments in the science of medicine have reduced the death rates materially in most countries during the past century, but birth rates have declined even more rapidly, largely, no doubt, because of the desire for better standards of living and the spread of information on family limitation. The result is that, though the total population is still increasing, the *rate of increase* is steadily declining. If we recall the fact that "average fecundity among modern, civilized women amounts to a total production of ten to twelve children, while the *actual* average number of children in

[4] Richard T. Ely, *Outlines of Economics,* New York, The Macmillan Company, 3rd ed., 1908, p. 436.

families of western civilization is less than three,"[5] we shall need no further evidence that the birth rate is being regulated.

The Effect of Fewer Births upon Wages.—In the practice of family limitation, or "voluntary parenthood," say the advocates of birth control, appears to lie a remedy for low wages. The plumber's wage is lower than that of the popular comedian, not because he renders a less useful service but simply because there are more good plumbers than good comedians, in relation to the demand for these two types of labor. It follows that plumbers could make themselves more fully appreciated by reducing their numbers, and that, once the relationship between good plumbing and human welfare was properly understood, they could command higher wages for their labor. But to be effective, the reduction in numbers, instead of taking place among plumbers only, would have to be applied to Group No. 3 (of Fig. 1) as a whole, and not to just one type of skilled workers within that group. For if plumbers were made so scarce that their wages were abnormally high for members of Group No. 3, it is probable that other members of the group, or their sons, instead of following the trade of machinist, carpenter, or electrician, would go in for plumbing and thus provide the competition that would pull down the high wages that limited numbers had brought the plumbers. However, if all members of the group were to insist upon higher standards of living, the attainment of which involved having only one or two children instead of five or six, there can be little doubt that the effect of their decision would be felt in the next generation. For if the theory of non-competing groups is sound, skilled workers would then be scarce, their marginal productivity would be high, and high wages would have to be paid to get their services.

The attainment of high wages through the limitation of numbers is not so far-fetched as it might, at first thought, appear to be. Indeed, the chief obstacle at present is lack of knowledge on the part of those who would benefit most by the practice of family limitation. They are ignorant, first of all, of the vital part that numbers play in wage determination, and, in the second place, of satisfactory ways of limiting the size of their families to the number of children they can provide for adequately. But these are matters regarding which the general public is becoming better informed all the time, and it is reasonable to suppose that the desire for higher standards of living—for more expensive auto-

[5] Ezra Bowen, *An Hypothesis of Population Growth*, p. 177.

mobiles, radio sets, fur coats, and the like—that is being built up by high-pressure advertising, will gradually lead the workers to adopt the means necessary to the attainment of such standards—that is, the control of numbers. It seems improbable, however, that we shall arrive at the situation, described by a writer of a century ago, in which "more persons will rather dine alone on champagne and chickens than share their roast beef and pudding with a wife and family."[6] The desire for home life and the parental instinct will doubtless prevent the movement for high standards of living from being carried to such extremes. But it is entirely possible that workers may some day refuse to have more children than their wages will provide not only with "roast beef and pudding" and other creature comforts, but also with educational and cultural opportunities such as are now virtually unknown among the working classes.

Economic Consequences of Stationary and Decreasing Populations.—The steadily declining rate of population increase, to which we have referred, will if continued bring us eventually to a point at which the birth rate is as low as the death rate, or even lower. We shall then have either a stationary or a decreasing population. Dr. L. I. Dublin, of the Metropolitan Life Insurance Company, in speaking of the situation in this country, says: "The continuation of the present tendency of rapid decline in the birth rate will in all probability result in bringing about a virtually stationary population in the United States by the year 1970. And at that time, under present immigration restrictions, the population of the United States will be approximately 150,000,000."[7] Assuming that we may count on improvements in production continuing for an indefinite period, a stationary population in this country would facilitate the attainment of higher and still higher standards of living with the passage of time. Standards have risen in recent years because production has increased more rapidly than population. If population were stationary, the same increase in production would cause standards of living to rise more rapidly than in the past; and if, as some students of population problems think probable, we should eventually have a decreasing population, these standards would improve at a still faster rate.

It seems fair to regard the steady decline in birth rates as a

[6] Quoted in *ibid.*, p. 201.

[7] L. I. Dublin, *Statistical Bulletin* of the Metropolitan Life Insurance Co., New York, January, 1930.

deliberate and persistent movement toward the realization of higher standards of living. If this decline spreads to the low-income groups, it will have the effect, in a generation or so, of limiting the quantity of labor in these groups, raising the wages of workers, and possibly even banishing the specter of poverty. The movement has been impeded somewhat by the threats of chauvinists and the entreaties of the clergy, and (in the United States) by legal prohibitions forbidding the dissemination of information on methods of birth control. But the practice of regulating the size of families has spread rapidly despite these obstacles, as is shown by the falling birth rates of all civilized countries. It still remains to teach the working classes, who need it most, the importance and technique of family limitation, for it is the upper and middle classes that have thus far benefited chiefly from this knowledge.

We shall not undertake here to defend the practice of family limitation against those who attack it on moral or religious grounds. This has been done so often by others that further comment on this point appears quite unnecessary. But we may close this part of our discussion with an excerpt from an argument by Professor Warren S. Thompson, which appears to many people to be quite unanswerable. "It would seem that we have now arrived at the stage of development where we could take account of the manner in which our lives are affected by population growth and could begin to adapt it intelligently to our needs," says Professor Thompson. "One cannot but wonder at the workings of a mind which will urge the study of natural processes so that man may learn to cooperate more fully with them to increase his control over the goods he desires, but which will stop short at man's control of his own fertility. We control the fertility of our horses and cattle to meet our need for power and food; we control the fertility of our fields, as far as is within our power, to meet our demand for agricultural products; and we control production of all other products as we see fit. Why should we not control our own fertility so that our numbers will be adapted to the particular circumstances in which we find ourselves at a given time?"[8]

Wages and Immigration

Immigration and American Wages.—Population and the supply of labor are always influenced by birth rates and death

[8] Warren S. Thompson, *Population Problems*, New York, McGraw-Hill Book Company, Inc., 1930, pp. 418, 419

rates, but they are sometimes affected by immigration as well. This is likely to be particularly true in the case of slightly developed countries with an abundance of natural resources. The United States during the past century is an excellent example. The increasing difficulties of making a living in Europe, and the apparently boundless opportunities offered here, drew millions to our shores. From 1820 to 1920, the population of the United States increased by almost 97,000,000 persons, and approximately one-third of this increase was by immigration. Has this influx of foreigners had any effect upon the wages of American workers? There seems to be little doubt that it has. For their coming has added materially to the quantity of labor; and an increase in the quantity of labor, whether it results from births or from immigration, inevitably makes wages lower than they would have been if the supply of labor had remained unchanged. If it is true, as Professor Ely says, that the marginal productivity and wages of labor have been held down by the growth of population during the past century and a half, then it is equally true that native American wage earners have suffered from the flood of immigration from Europe to the United States. For some thirty or forty years our immigrants have been made up chiefly of laborers from southern and southeastern Europe who, by their competition for jobs, have doubtless done much to hold down the wages of common manual labor and semi-skilled workers in this country.

The Restriction of Immigration.—Naturally, the workers have not been blind to the fact that these additions to the labor supply in America (amounting, in each of several years, to a million or more persons, as is shown in Table 4) have been

TABLE 4.—IMMIGRATION TO THE UNITED STATES, 1905–1914[a]

Year	Number	Year	Number
1905	1,026,499	1910	1,041,570
1906	1,100,735	1911	878,587
1907	1,285,349	1912	838,172
1908	782,870	1913	1,197,892
1909	751,786	1914	1,218,480

[a] Source: *Statistical Abstract of the United States, 1937*, p. 95.

injurious to their economic interests. There have been, as a consequence of the resentment engendered by the competition of these

newcomers, many impassioned demands for the restriction of immigration, but it was not until 1921 that legislative measures were adopted limiting materially the number of immigrants that would be admitted annually into this country. The immigration law has since been changed several times, and as matters now stand a total of only 150,000 immigrants is admitted to the United States each year from countries of the eastern hemisphere, on a quota basis that allots more than two-thirds of this total to England, Ireland and Germany. Special concessions are made to natives of the western hemisphere, in that immigrants who were born in Canada, Mexico, Cuba, Haiti, the Canal Zone, and the independent countries of Central and South America, together with their wives and children under eighteen, are classified as "non-quota immigrants" and admitted without limit.

The net effect of this National Origins Act, which became effective in 1929, has been to cut down the total immigration to the United States to about 250,000 persons a year. There is continual agitation for more stringent restrictions, and particularly for some limitation upon the numbers admitted from Mexico and Canada. Whether the restrictive measures that have been proposed will be made law cannot, of course, be predicted with any degree of safety at this time.

Overpopulation and Migration.—When a region becomes so densely populated that the standard of living is unbearably low, the more venturesome members of the group commonly go forth in search of economic opportunities that are not to be found at home. There is evidence that economic considerations have played a large part in practically all great migrations of the past. Certainly it cannot be doubted that the flood of Europeans to the United States during the past century—"the largest movement of immigrants into any country known to history"—was brought about chiefly by the desire to escape from the low standards of living of the Old World and share in the high standards of the New. The high real wages of the United States could not fail to attract the less favored wage earners of Europe. Hence, in the absence of immigration barriers, more than 35,000,000 Europeans migrated to the United States, and an overwhelming majority of these millions became a permanent part of our population and labor supply.

During the greater part of its existence as a nation, the United States has pursued the policy of encouraging immigration. America

was to be the land of opportunity, the place of refuge for all oppressed peoples. But there comes a time in the affairs of nations when it seems wise to change policies. This time came, in the case of American immigration, when the workers of this country insisted upon having protection against the swarms of European competitors whose entrance into the United States imperiled "American standards of living." Our present policy is embodied in the National Origins Act, which we sketched briefly above.

The Case for Restriction of Immigration.—There are some who question the justice of excluding from the advantages that we enjoy, the people of other nations who would like to share these advantages with us. It is often urged that we should continue to admit the overflow of population from crowded countries. But migration is not a genuine remedy for overpopulation. Italy is an example of the futility of migration as a solution of the problem of overcrowding. According to Signor Mussolini, "Italy each year produces an excess of 500,000 men who must in one fashion or another emigrate."[9] If this number must migrate every year, as Mussolini says, it is obvious that finding places for them elsewhere does nothing to raise the low standards of living that overpopulation has brought to Italy. All that this annual migration can do is to prevent the situation in Italy from getting worse, and this it does at the expense of the workers of those countries to which the emigrants go. This can scarcely be called a satisfactory solution of the problem of overpopulation; rather, it is what is popularly known as "passing the buck."

The true remedy for overpopulation, like charity, begins at home. Nations that do not want larger populations should not be expected to admit immigrants unless the country that seeks to dispose of its excess is earnestly trying to hold its birth rate down to a figure as low as its death rate. There are many who believe that the goal to be aimed at is the total exclusion of immigration from any country that has an increasing population. If one with a stationary or decreasing population wishes to raise standards of living by relieving the pressure of population upon its resources, it would appear to deserve help in placing some of its people elsewhere. But a nation that has not set its own house in order by controlling its birth rate should be made to understand that it cannot dump its surplus numbers upon countries that have no

[9] *New York Times*, January 11, 1926. Signor Mussolini made several similar statements in undertaking to justify his conquest of Ethiopia.

need for them and do not want them. Labor, in its attempt to raise real wages by the exercise of family limitation, feels amply justified in demanding that its efforts shall not be frustrated by hordes of immigrant workers coming in from countries that give no heed to a proper adjustment between population and national resources. Migration is at best a temporary expedient for relieving overpopulation. It is upon the intelligent control of numbers that we must depend for high per capita incomes; and it is to such control within particular income groups that workers must look for the attainment and maintenance of high wages.

Mobility of Labor and Commodities.—Since we shall endorse free trade, or the unobstructed movement of goods between countries, when we discuss the tariff problem,[10] it may appear inconsistent to advocate the restriction of immigration in the present chapter. If tariff barriers are to be done away with, why not also remove all obstacles to migration? Is not the free flow of labor comparable to the free flow of goods? No; the two are not strictly comparable, at least not in their economic consequences. The removal of tariff barriers would lead to a readjustment of business based on geographical specialization, and business so adjusted would bring more commodities and services to the country formerly "protected," as well as to the countries whose goods had previously been shut out by tariff duties. But the removal of immigration barriers, unless accompanied by population control, would injure some nations by flooding them with millions of immigrants and yet bring no lasting benefit to the countries whence these people came. The admission of 500,000 Italian laborers annually to the United States would unquestionably pull down the wages of American workers, but would not raise standards of living in Italy, since the places of the half million (if Signor Mussolini's figures are correct) would be filled promptly by Italy's excess of births over deaths. It is quite possible, then, and without inconsistency, for a person interested in high wages for labor to approve of the free movement of goods and at the same time, in the absence of stationary or decreasing populations, to oppose the free movement of labor from country to country.

Another question that is sometimes asked in this connection is whether foreign labor does not compete just as severely when it stays at home as when it emigrates. For example, do not Italian workers in Italy, by making goods that sell in competition with

[10] In chap. 11.

American products, pull down the wages of American labor to as great an extent as though they came to the United States and competed directly? Again the answer is in the negative. Obviously, if a high protective tariff is in effect, the Italian goods and therefore the Italian labor will be unable to compete within the American domestic market. Even in the foreign markets from which goods are not artificially excluded, we find that American products made by highly paid labor can be and are sold as cheaply as the products of other countries made by poorly paid workers. Though American wages are high, the workers here, equipped with an abundant supply of land and capital of high quality, turn out goods so efficiently that the labor cost per unit is extremely low. Italian laborers working in Italy with limited quantities of poor equipment are much less productive than American workers, and do not affect the American wage scale; but if transferred to the United States and put to work here, they would offer direct competition to American labor and their presence would tend to pull down wages in this country.

If world-wide free trade were instituted while present immigration barriers were retained, the laborers of all nations would presumably be set to work making goods, in the production of which their respective countries enjoyed a relative advantage. Real wages would probably rise throughout the world, but differences in the wage levels of the various countries would not be wiped out. Wages then, as now, would depend upon the importance of labor in the productive process, and labor's importance, as measured by its marginal productivity, would in turn depend upon the quantity and quality of land, labor, and capital existing in a given country. If Italy and the United States should chance, under free trade, to compete in the manufacture and sale of a particular commodity, the productive advantages of this country would permit the payment of the prevailing high wage for American labor of the kind used and still allow the article to be sold at the same price as the Italian-made goods. If this were not the case, American labor would leave this particular industry, moving into other lines of work in which similar workers were enjoying better wages, and the industry in question would eventually disappear because of its inability to stand up in the face of Italian competition. We repeat, then, that it is direct competition, and not indirect competition of the kind we have been discussing, that the highly paid wage earners of the United States must guard against.

Conclusion.—We have seen that the size of the population plays an important part in the determination of wages through its influence upon the supply of labor in particular wage groups. Since labor is inextricably tied up with human beings, the supply of labor is practically fixed for short periods of time. In the long run, however, wages can be raised by reducing the supply of labor of a given type, if the demand for workers of this kind does not decline equally fast. Through the practice of family limitation, the low-wage groups could raise their real wages in the course of a generation, if at the same time they saw to it that immigration from other countries was stopped. The small families of the middle and upper classes are evidence of the prevalence of birth control. The high standards of living enjoyed by members of these classes indicate that restriction of numbers is rewarded with higher real wages. The solution of the problem of low wages, therefore, appears to many persons to lie in the refusal of parents to have so many children that their income will not provide a reasonably high standard of living for the family. But this remedy cannot readily be made available for those who need it most unless we abolish our legal taboos against instruction in scientific methods of family limitation. Since legislative restrictions of this kind interfere with the reduction or elimination of poverty, the removal of such restrictions is a goal toward which many socially minded persons are working today.

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1. If we are to get an accurate impression of the social significance of wages, we must deal with *real annual* wages. Why would not *daily money* wages answer the purpose equally well?
2. The United States has 35 people to the square mile and a per capita wealth of $3000; Italy has 357 people to the square mile and a per capita wealth amounting to $833. Do you think it probable that low real wages in Italy and high real wages in the United States are in any way related to density of population and per capita wealth? Explain.
3. "The per capita income of the United States is $750. This means a total income of $3750 per year for the hypothetical family of five. This amount is sufficient to buy a good standard of living. Therefore, there is no problem of poverty in this country." Analyze this statement, and pass upon its soundness.
4. "Labor is a commodity, and the price paid for it, like the price of any other commodity, is determined by conditions of supply and demand." Criticize.

5. It is said that wages tend to equal the marginal productivity of labor; and yet a worker may receive different wages in two different years, even though he works just as hard in one year as in the other and turns out precisely the same number of units of product in each of the two years. Explain.
6. Define "optimum population."
7. What is meant by "non-competing wage groups"? How does the existence of such groups bring about differences in wages?
8. What are the factors that prevent a free movement between these so-called non-competing groups?
9. Why do these groups tend to remain *non-competing* even over long periods of time?
10. It is said that "proportionality" enters into the determination of wages. Explain the meaning of this term in this connection.
11. State the Subsistence Theory of Wages.
12. What evidence have we that the Subsistence Theory of Wages is unsound?
13. How are standards of living related to wages?
14. If it is true that wages are paid workers on the basis of their importance to society, how do you account for the fact that garbage collectors, whose services contribute greatly to the maintenance of public health in crowded communities, receive wages that are far lower than those of our comedians, who merely make us laugh?
15. In 1930, Charlie Chaplin was offered $650,000 for a weekly radio broadcast of fifteen minutes over a period of twenty-six weeks. The offer, therefore, was at the rate of $100,000 per hour. Has a wage of this kind anything to do with marginal productivity? Does it bear any relation to population or the supply of labor? Explain.
16. What is Professor Ely's conclusion of the effect of population growth upon American wages, during the past century and a half? How does he arrive at this conclusion?
17. What has the United States done to limit the admission of immigrants?
18. Explain how the restriction of immigration, used in connection with the practice of family limitation, is likely to affect wages.
19. Would you expect the effect to be immediate or long-deferred in the case of (a) restriction of immigration, and (b) restriction of numbers by birth control?
20. How may a country solve the problem of overpopulation, if denied the privilege of sending its people to other countries?
21. Must not the advocate of free trade, to be consistent, champion also the abolition of immigration barriers?

22. Do Japanese workers, when they remain in Japan, compete with Americans as seriously as though they came to the United States and found jobs here? Explain.

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PROBLEMS OF FINANCE

6 COMMERCIAL AND INVESTMENT BANKING

CREDIT IS A TERM IN VERY COMMON USE TODAY, BUT ONE WHICH HAS A VARIETY OF MEANINGS. IN GENERAL, CREDIT MAY be said to mean the exchange of present goods for an equivalent which someone undertakes to furnish within a stated period of time. Our definition of credit in general must be couched in broad terms, because it must be made applicable to many different operations, ranging from the pledge of a saxophone at a pawn shop or the purchase of groceries to be paid for after a short time, to the sale of many millions of dollars' worth of bonds for the purpose of adding to the capital equipment of a railroad. In connection with banking, however, "credit" is the word used to refer to loans made by or through banks to individual business men or companies.

Commercial and Investment Credit.—Credit, as extended through the banks, may be divided into two classes, investment credit and commercial credit. These two types of credit may be distinguished on the basis of three criteria: (1) The use to which the funds are put, (2) the length of time for which the credit is extended, and (3) the amount of credit that is granted in a specific instance. Investment credit consists of long-time loans, amounting to large sums, and made for the purpose of acquiring fixed capital. The availability of the future equivalent which is expected by those who, in the last analysis, furnish this type of credit, depends as a rule upon an enhanced productivity on the part of the business that makes use of the investment credit in question; that is, the investment credit must be used productively if the loan and interest on it are to be paid when due. Commercial credit, on the other hand, consists of loans of relatively small amounts, extended for short periods of time, and used for supplying working capital. The line of demarcation between investment and commercial credit is not, however, so sharp and clear cut as might appear from this brief description. In reality, the one shades into the other gradually and the connection between them is often very close. Neverthe-

less, we may in general take commercial credit to mean loans for a duration of 120 days or less, which will tend to be liquidated through the sale of existing goods or goods which are about ready for sale.

Commercial Banking

The statement that we live today in an exchange economy is a commonplace of economics. Very few persons produce commodities and services exclusively for themselves. Each individual is a specialist who as a rule performs only a single economic function, and relies upon the exchange process to enable him to obtain the many economic goods which he desires. Barter, or the direct exchange of commodities and services for commodities and services, would be extremely cumbersome and would be attended by well-nigh insuperable difficulties in the present stage of our economic development. Exchange is therefore carried on indirectly, through the use of what is called a medium of exchange. Actual money is still of some importance as a medium of exchange, but for this purpose it is now overshadowed by credit instruments, for it has been estimated that about 90 per cent of business of the United States is carried on through the use of credit instruments such as checks and other drafts.

The Need for Commercial Credit.—In the operation of our modern economic system, business men and companies continually find themselves in possession of certain special forms of purchasing power, or claims upon the wealth of the community. These may, for example, take the form of goods finished but unsold, or goods sold but not paid for. In time, through the process of exchange, payment for their goods will be received by these business men and companies. In the meantime, however, the smooth, efficient operation of business demands that further raw materials be purchased, that wages be paid, and that the other regular expenses of business operation be met when due.

In these situations, commercial banks are able to render a great service to business men. By means of short-time loans, these banks substitute their purchasing power of general acceptability (money, or deposits subject to check) for the purchasing power of limited acceptability (goods, notes, or drafts) which is possessed by the business men and firms. In this way these business organizations are able to command at once the commodities and services which they require, and are expected later on to pay their debts to banks,

with interest. From the point of view of individual business concerns, loans are granted and credit is extended from time to time. From the point of view of the country as a whole, an enormous volume of commercial credit is constantly in use, which provides through the use of credit instruments a very important part of the mechanism of exchange.

The Problem of Commercial Banking.—It will be seen, therefore, that an essential of a sound commercial banking system is elasticity of currency and commercial credit. The system must be able to expand currency and credit to meet the needs of expanding business, and to contract it as the need lessens. At the same time, currency and credit should be expanded and contracted in such a way, and to such an extent, as to avoid, so far as is possible, the inflation of prices, the overstimulation of certain industries, recessions in business activity, and bank failures, which bring economic hardship and suffering to millions of persons. To attain elasticity of currency and credit, and at the same time to provide safety for depositors, is the problem of commercial banking.

THE PROBLEM OF ELASTICITY

Inelasticity Under the National Banking System.—Before the adoption of the Federal Reserve System, commercial banking in this country failed to provide an adequate measure of elasticity and safety. The principal form of currency in use under the National Banking System, the national bank note, could not be expanded or contracted readily in response to business needs, because these notes could be issued only on the basis of a 100-percent reserve in the form of certain government bonds, the amount of which did not increase or decrease with changes in business activity. Even more important was the fact that commercial credit could be extended by the banks only up to the amount for which they held the legal minimum reserves. Facilities were lacking whereby banks could rediscount commercial paper received from their customers and put themselves in a position to extend further commercial credit to their customers. The result was, to repeat, an inelastic system of currency and commercial credit, and yet one, withal, which was not adequately safeguarded.

An Elastic Currency.—Under the Federal Reserve System, which began to operate in 1914, a new form of currency, called the Federal Reserve note, came into use. This is our most important form of paper money today, and one that may be expanded

or contracted in response to business needs. Elasticity is secured by the provision that the usual security for Federal Reserve notes, aside from a minimum gold certificate reserve of 40 per cent, shall be commercial paper—that is, short-term promissory notes and drafts which represent actual business transactions. Whenever business is very active, banks extend large amounts of commercial credit to business men, and have in their possession correspondingly large quantities of commercial paper which can be used as a basis for the issuance of Federal Reserve notes as long as the Reserve banks retain the necessary gold certificate reserves. On the other hand, when business is dull, loans tend to be paid off faster than new loans are made, so that there is a decline in the quantity of commercial paper eligible for use as security for Federal Reserve notes. Thus, the notes expand and contract with business needs.

The notes are issued through the Federal Reserve banks, and it is these banks also that must keep the minimum gold certificate reserve and hold the eligible commercial paper brought in by the member banks to be rediscounted and used as the basis for note issue. To be eligible for these purposes, commercial paper must represent actual industrial, commercial, or agricultural transactions, and must be indorsed by a member bank. The maximum maturity of commercial paper at the time of rediscount is ninety days, except in the case of agricultural paper, which may be for nine months.

Elasticity of Commercial Credit.—The large reserves which are accumulated under the Federal Reserve System may, however, be used more effectively as the basis for a great superstructure of commercial credit than as part security for the issuance of Federal Reserve notes. Since by far the greater part of the business of this country is carried on through the use of credit and credit instruments and not through the use of money, a tremendous volume of commercial credit may be extended and utilized without any great amount of money being used. Consequently, unless a member bank is in need of money when it takes eligible commercial paper to the Reserve bank to be rediscounted, it is very likely to leave the proceeds of the loan on deposit at the Reserve bank, where it will count as legal reserve against the deposits created by the member bank. Upon the basis of this new reserve, then, the member bank may issue commercial credit to business men up to several times the amount of the proceeds of the rediscounting. In

addition to the rediscounted paper, the Federal Reserve bank must hold, in gold certificates or other lawful money, a reserve of 35 per cent of the amount of deposits which member banks keep with it, as compared with a 40-per-cent gold certificate reserve in the case of Federal Reserve notes.

The Control of Elasticity.—In general, the Federal Reserve System has been successful in providing a degree of elasticity of currency and credit that takes care of our changing business needs; but once elasticity is attained, a new difficulty arises. This is the problem of controlling elasticity in the issuance of currency and credit—for uncontrolled elasticity may be quite as bad as inelasticity, or even worse. There have been differences of opinion, since the inception of the Federal Reserve System, as to the best policy to pursue in controlling the issuance of currency and credit. Some people have gone so far as to insist that the System should undertake to stabilize business activity and eliminate recurrent periods of prosperity and depression through the control of money and credit. It seems probable that the Federal Reserve System could perform this function only if the following assumptions are sound: (1) That periods of business prosperity and depression could be eliminated if the general price level were stabilized; (2) that the general price level could be stabilized through centralized control over the issuance of money and credit; and (3) that the Federal Reserve System has at its command devices which would enable it to control the quantity of money and credit in circulation.

The first of these assumptions is debatable. There are economists, of course, who contend that business cycles are the result of the "dance of the dollar" and would disappear if the general price level were stabilized. It seems to us, however, that business cycles might occur even under a stable general price level, although they would probably be significantly reduced in severity. Our experience since the World War has demonstrated that extensive business fluctuations may take place in the presence of a fairly stable level of wholesale commodity prices, though this is by no means the same thing as a stable *general* price level. The second assumption appears to be more firmly grounded. But it is doubtful whether the Federal Reserve System has ever had, or now has, at its disposal devices entirely adequate for controlling the expansion and contraction of currency and credit. Hence, the third of the assumptions listed above may be seriously questioned.

However, though some critics suggest that trying to stabilize

business by controlling currency and credit is comparable to trying to equalize the temperature of a room by regulating the thermometer, it seems that money and commercial credit might well be controlled so that they would merely perform their function of facilitating the operation of business. That is, they should not be issued in such ways and amounts as will raise general prices, stimulate business activity, increase profits and overinvestment in plant and equipment, reduce real wages and labor's purchasing power, and otherwise bring about conditions which will later lead inevitably to business depression. Nor should the quantity of money and credit be decreased so sharply as to precipitate business crisis, liquidation, and depression when these predicaments might be avoided. Money and credit are legitimate devices for avoiding the inconveniences of a barter economy, and for facilitating the operation of economic activities which, in the interests of society, should be carried on even if money and credit did not exist. But they have often been used in socially harmful ways, as we have seen. Whether or not they can be controlled so as to stabilize business activity, they certainly must not be allowed to be a principal factor in bringing about instability.

Control of Rediscount Rates.—Our experience with the Federal Reserve System indicates that it has been more successful in providing elasticity than in confining money and credit to their legitimate, neutral rôle of facilitating exchange. Despite the powers vested in the System, the issuance and withdrawal of money and credit have sometimes been allowed to stimulate business artificially, and at other times have made for depression. These unhappy results are attributable in part to a lack of sufficient authority, and in part to conditions inherent in the administration of any system of credit control.

One of the powers originally granted the Federal Reserve System for controlling money and credit was authority to raise and lower the rediscount rate. When an undue expansion seems imminent, Reserve banks may raise the rediscount rate, with the approval of the Board of Governors of the System. This rise means, in effect, an increase in the price which member banks must pay for additional money or credit, that is, for loans extended the member banks on the basis of eligible commercial paper indorsed by them and pledged with the Federal Reserve banks. The results which should follow changes in rediscount rates are quite clear in theory. A rise in the rate makes it more expensive

than formerly for member banks to obtain credit from the Reserve banks. It should follow that the member banks will charge their customers higher rates for additional commercial credit and that the customers will consequently limit their new loans, and extensions of old loans, to amounts which are absolutely essential. When this occurs, the expansion of credit will be checked. Similarly, lowering the rediscount rate when business is slack makes it easier for member banks and their customers to borrow, and thus encourages them to increase their loans.

The Effectiveness of Changes in Rediscount Rates.—In actual practice, however, raising and lowering the rediscount rate has not been an effective device for controlling the expansion and contraction of money and commercial credit. In the first place, a considerable expansion of credit sometimes gets under way without recourse to rediscounting by member banks, because of large reserves which they have idle at the beginning of a period of active business. In the second place, when a bank rediscounts in order to increase its reserves with a Federal Reserve bank, it acquires a greater lending power than appears on the surface. If a bank adds $1000 to its reserve by rediscounting, it is enabled to lend much more than that sum to business men in the form of demand deposits, even if other member banks are not doing the same thing. While opinions differ on this point, it is probable that the member bank could lend at least $1500 in demand deposits to business men on the strength of an increase of $1000 in its legal reserves. This is possible because loans in the form of demand deposits are not always entirely checked out by the borrowers and, when checks are drawn against such deposits, they are often redeposited in the same bank. Thus, a bank, by obtaining $1000 through rediscounting at 5 per cent, is enabled to lend, say, $1500 to business men at 6 per cent. And even if the rediscount rate is raised, the bank may continue to lend extensively and profitably to its customers without charging them more than the former rate of interest, namely, 6 per cent.

Of course, when a member bank obtains an additional reserve of $1000 in this way, it ordinarily has the *legal* right to increase the demand deposits of its customers up to $10,000, on the average, because of the small legal reserve required on demand deposits. This right, however, cannot be exercised by one bank alone. If a single bank expanded its deposits in this way, the enlarged deposits would cause a very large number of checks to be drawn

against the bank by its depositors. The clearing house claims against this bank would then be much larger than the bank's claims against the other banks in the clearing house. These daily net adverse balances would eventually drain away much of the bank's working cash, and force it to reduce its deposits. However, when all or most member banks are rediscounting and expanding credit, a given bank may reach something approaching the maximum legal average expansibility of ten times the amount of reserve added by rediscounting; for under these circumstances the checks drawn by its customers against demand deposits are largely offset by the checks it receives which are drawn on other member banks. If this is the situation, even a 5-per-cent rise in the rediscount rate would mean a rise of only one-half of one per cent, or a little more, in the interest rate charged to business men. Consequently, the member banks might not raise their interest rates at all.

Even if this policy of the Federal Reserve control succeeded in raising the rates which member banks charged business men, the rise might not check borrowing greatly. When a business man expects to make a profit of 10 or 20 per cent by using borrowed funds, he is unlikely to be restrained by the necessity of having to pay, say, an additional one per cent for these funds. Finally, it is entirely possible that our domestic policy of control might be upset by concerns in foreign countries, should they decide to take advantage of the high interest rate by making us extensive loans. And even domestic corporations with idle funds might throw them into the market if the interest rate obtainable were very high.

Open-market Operations.—The other major Federal Reserve device for controlling commercial credit has been open-market operations. This device functions through the rediscount rate also, and can scarcely be more successful than the rediscount method of control. That is, when there is danger of commercial credit being overexpanded the Federal Reserve banks may decide to sell, say, a billion dollars' worth of government bonds in the open market. These securities will be bought by business men, corporations, banks, and other financial institutions. Let us suppose, for the sake of simplicity, that they are all bought by business men who pay the Federal Reserve banks with checks drawn on demand deposits in member banks. These checks will be charged by the Federal Reserve banks against the reserve accounts of the member banks. This will lower the legal reserves of the member banks by

a billion dollars, and the demand deposits which they may legally extend by roughly ten times this amount. Hence, the member banks will have to curtail credit or replenish their reserves by rediscounting at the Reserve banks. If they do the latter, they will find that they must pay a higher rediscount rate than before. In this way, the open-market operations are intended to make the changes in rediscount rates effective in checking the expansion of credit; but it may be questioned whether a rise in the rediscount rate will be more effective because it operates indirectly instead of directly. When business is slack, the purchase of securities in the open market by the Reserve banks is expected to increase the reserves and idle funds of the member banks, and thus stimulate lending by these banks.

Credit Control in Depressions.—Until recent years, these were the only powers held by the Federal Reserve System for controlling commercial credit, other than the doubtful means of persuasion and exhortation. Ineffective as these measures have been in preventing the overexpansion of credit, they have probably been even less successful in checking the contraction of credit. In periods of poor business, there is ordinarily little or no rediscounting, so that a lowering of rediscount rates means little. At such times, member banks would be likely to lower their interest rates to business men in any case. If idle funds are thrust upon member banks through open-market operations, the banks are likely to use them to get out of debt and increase their liquidity, rather than to make new loans to business men. The crux of the matter is that, in a period of declining business, enterprisers do not want to borrow from member banks for normal commercial credit purposes and the banks are not anxious to lend. When a business man feels that he cannot make profits by using borrowed funds, he is unlikely to borrow even if the interest rate is only one per cent.

Thus far we have been considering the adequacy of the credit control powers of the Reserve System, but there are other points to be examined. However adequate these powers might be, there remains the difficult matter of deciding just when they shall be used. To determine precisely when the further issuance of money and credit would be unsafe, it would be necessary for the officials in charge to possess almost superhuman knowledge and ability. And yet the control must be applied at exactly the right time if it is to be effective and not restrain desirable business activity. Even if it were possible to determine exactly when control should be

exercised, it would take great courage to adopt the necessary measures in the face of the economic, political, and international pressure which would be exerted by those who would be adversely affected.

Recent Additions to Control Powers.—In the Banking Acts of 1933 and 1935, changes were made in the organization of the Federal Reserve System and in its credit control powers, which may be of some assistance in the future. In the first place, under the Act of 1935, the Federal Reserve Board was replaced by the Board of Governors of the Federal Reserve System. The new Board consists of seven members, all appointed by the President of the United States, with the approval of the Senate. The Secretary of the Treasury and Comptroller of the Currency, *ex officio* members of the old Board, are not members of the new one. Members of the new Board serve for a new long term of fourteen years at a salary of $15,000 per annum, and their terms expire in rotation, one in each two-year period. They may not be reappointed. These changes are intended to increase the independence and detachment of the Board, and to enable it to exercise its powers, when necessary, without fear of outside factors.

Increased powers have also been granted the Board of Governors of the System. This Board now constitutes a majority of the membership of the Federal Open-Market Committee, and can control its decisions. Formerly this Committee of twelve was elected to represent the twelve Federal Reserve banks. Today, only five of the twelve represent these banks. Moreover, the decisions of the Committee to engage or not engage in open-market operations are now binding on the Reserve banks. These banks must submit their proposed rediscount rates to the Board of Governors at least once in every two-weeks period, and the rates must be approved by the Board before they become effective. This gives the Board of Governors control, for all practical purposes, over the rediscount rates charged by the Federal Reserve banks.

In addition to being given direct authority over rediscount rates and open-market operations, the Board has received other new powers for controlling commercial credit. First, it may now increase the reserve requirements that member banks must hold against demand and time deposits, by any amount up to double the long-established requirements of 13, 10, and 7 per cent (3 per cent for time deposits) for the three classes of member banks. The Board exercised this power by doubling these requirements

temporarily, as of May 1, 1937, only to reduce them to 22¾, 17½, and 12 per cent as of April 16, 1938. The rates may be still further reduced, but not below their long-time level of 13, 10, and 7 per cent. Doubling the reserve requirements for member banks has the effect of reducing by one-half the ability of these banks to extend demand deposits to business men on the basis of a given amount of reserves.

The Board of Governors may fix, for each Federal Reserve district, the percentage of a member bank's capital and surplus which may be extended to borrowers in the form of loans secured by stock and bond collateral. This percentage may be changed upon ten days' notice. After investigation and hearing, the Board may deny the credit facilities of the System to any member bank which appears to be lending too extensively for speculation in securities, real estate, or commodities. This power permits the Board to refuse rediscounting facilities for speculative purposes, while allowing credit to be expanded for normal business operations. Through its control over "margin" requirements, the Board also determines the percentage of the market values of securities that member banks may lend. Finally, the Board may suspend or remove any officer or director of a Federal Reserve bank, or of member banks, for continued violations of law, or unsafe and unsound banking practices.

These changes should strengthen to some extent the control of the Federal Reserve System over the elasticity of commercial credit. If the Board of Governors should decide to raise rediscount rates and to engage in open-market operations, and at the same time should double the reserve requirements behind demand deposits for member banks, and cut off rediscounting facilities for erring member banks, it should be able to halt almost any movement toward the overexpansion of credit. It is not equally clear that the Board's control over the contraction of credit has likewise been strengthened, though it may be argued that, if expansion is controlled, the problem of regulating contraction will be greatly simplified. It remains true, however, that credit control must be exercised wisely and courageously, if desirable ends are to be reached.

THE PROBLEM OF SAFETY

Insecurity Under the National Banking System.—Our commercial banks failed to provide safety for depositors prior to the

introduction of the Federal Reserve System. Though national banks had to keep fairly large reserves behind demand and time deposits, the system of reserves was unsatisfactory in at least two respects. In the first place, the national banks were required to hold only a part of their legal reserves in cash in their own vaults. The remainder might be deposited at interest with other banks; and these funds could seldom be regained in time of emergency, for the other banks often treated the deposited reserves just like any other deposits, lending or investing them while retaining only the minimum legal reserve against them.

However, even if the national banks' total reserves had been readily obtainable in time of emergency, it would still have been impossible to pay off all the depositors with the reserves of 25, 25, and 15 per cent, which the three classes of banks were required to hold against demand deposits. The second weakness of the old system, then, was the inability of the national banks to obtain additional funds in case of need. There was no central agency from which the national banks could borrow, in order to meet the demands of their depositors when their own reserves ran low.

Safety Under the Federal Reserve System.—One of the purposes of the Federal Reserve Act, as originally passed, was to alter these conditions so as to provide safety for the depositors of member banks. Though the actual percentages of reserves required against deposits were reduced, rather than increased, every member bank was compelled to keep its reserves in the Federal Reserve bank of its district, without interest. Then, in case of emergency, the Reserve bank could place at the disposal of a distressed bank not only the member bank's own reserve, in the form of cash, but additional funds from the great pool of reserves which it held for the other member banks of the district. For the Federal Reserve Act provided that a member bank should be permitted to obtain additional funds, when necessary, by rediscounting eligible commercial paper at the Federal Reserve bank. It was thought that this provision would make it unnecessary for a member bank to close its doors because of inability to obtain funds. To make assurance doubly sure, it was arranged that funds could be shifted from one district to another, in case there were runs on many member banks in a single district at a given time.

Bank Failures in Recent Years.—Many people, firmly convinced that banks could not fail under the Federal Reserve System, were greatly shocked and highly indignant at the large number

of bank failures that took place even in good business years, and the almost total collapse of the banking system and unprecedented toll of failures that marked the depression years of 1929-33. Table 5 throws light on the bank failures of recent years, and shows that most of them have been among non-member banks. In the whole period from 1925 to 1932, inclusive, 2.4 per cent of all member banks failed, on the average, while 5.5 per cent of all non-member banks met a similar fate; so that the percentage of failures was well over twice as great for non-member as for member banks. Examining the deposits of failed banks, we note again the heavier casualties among the non-member banks. In this eight-year period, only seven-tenths of one per cent of the total deposits of member banks were tied up by bank failures, on the average, whereas 1.7 per cent of the total deposits of non-member banks were similarly involved.

Member and Non-member Bank Failures.—During four years of depression, from 1929 to 1932, inclusive, when the safety of both member and non-member banks was given a severe test, 4645 of the 5761 failing banks were non-members. Let us examine these figures more closely. In 1929 there were roughly twice as many non-member as member banks. If member and non-member banks had been equally safe (or equally unsafe), we should have expected the ratio of failures between non-member and member banks to be two to one. Actually the ratio was greater than four to one. This comparison indicates that member banks provided a substantially higher degree of safety for depositors than non-member banks during the great depression.

In 1933, shortly after the inauguration of President Roosevelt, a bank holiday was declared and all banks in the country were closed. After a few days, the banks which seemed to be sound were licensed to reopen, while the others were required to put themselves in satisfactory condition or eventually be liquidated. Table 5 presents, for member and non-member banks, data of the suspensions of banks licensed to reopen, and of the liquidation of banks not licensed to reopen, for the years 1933 to 1938. Of the banks licensed to reopen after the bank holiday, about fifteen times as many non-member as member banks were later suspended. However, during this period, almost as many member as non-member banks were denied licenses, and were liquidated or thrown into receivership.

The failure of non-member banks should not, of course, be

charged against the Federal Reserve System. Non-member banks make loans on types of securities, for lengths of time, and for amounts that would not be permitted under the Reserve System, and they persist in following banking practices which would not be tolerated in a member bank. Their reserves are not kept in accordance with the provisions of the Federal Reserve Act, but need comply only with those of state banking laws. In many cases their capitalization is smaller than the minimum required of a

TABLE 5.—BANK FAILURES IN THE UNITED STATES, 1925–1938[a]
MEMBER BANKS

Year	Number of Member Banks	Number of Member Bank Failures	Percentage of Member Banks Failing[b]	Total Member Bank Deposits (in Millions)	Deposits of Failed Member Banks (in Millions)	Deposits of Failed Member Banks as a Percentage of Total Member Bank Deposits
1925	9,489	146	1.5	$30,029	$ 65	0.2
1926	9,260	158	1.7	30,474	67	0.2
1927	9,034	122	1.3	32,063	63	0.2
1928	8,837	73	0.8	34,826	47	0.1
1929	8,522	81	0.9	33,865	58	0.2
1930	8,052	188	2.2	32,560	373	1.2
1931	7,246	516	6.4	27,432	733	2.7
1932	6,816	331	4.6	24,803	269	1.1
1933 (2 mos.)	6,011	89	1.3	23,771	95	0.4
Average through 1932			2.4			0.7

Year	Banks Licensed but Later Suspended	Deposits (in Millions)	Non-licensed Banks in Liquidation or Receivership	Deposits (in Millions)
1933 (10 mos.)	11	$19.2	509	$1,614
1934	1	0.04	421	429
1935	4	5.3	10	15
1936	1	0.5		
1937	6	9 1		
1938 (2 mos.)	1	0.04		

[a] Sources: *Annual Report of the Federal Reserve Board*, 1926–1936, and *The Federal Reserve Bulletin*, April, 1938, Washington, The Federal Reserve Board.

[b] Since the figures for the number of member and non-member banks are as of December 31 of the years given, the number of bank failures for each year is figured as a percentage of the number of banks at the end of the preceding year.

member bank, and the supervision to which they are subjected is often in no way comparable to that prescribed for member banks. The Federal Reserve System has no control over non-member banks, and has no authority to extend aid to them when they are in distress.

The Causes of Member Bank Failures.—In spite of the relatively favorable safety record of member banks in the depression years of 1929-33, many people feel that altogether too many

NON-MEMBER BANKS

Year	Number of Non-member Banks	Number of Non-member Bank Failures	Percentage of Non-member Banks Failing[b]	Total Non-member Bank Deposits (in Millions)	Deposits of Failed Non-member Banks (in Millions)	Deposits of Failed Non-member Banks as a Percentage of Total Non-member Bank Deposits
1925.......	18,768	472	2.5	$19,195	$103	0 5
1926	18,107	818	4 4	19,681	193	1.0
1927.... ..	17,382	547	3 0	20,846	136	0.7
1928.....	16,739	426	2 5	21,940	96	0.4
1929.	16,108	578	3 5	21,424	173	0.8
1930.......	14,717	1,164	7 2	20,479	480	2 3
1931.... ..	12,720	1,778	12 1	18,389	958	5.2
1932......	11,574	1,125	8.8	16,840	447	2.7
1933(2 mos.)	9,000	373	3.2	14,734	123	0.8
Average through 1932			5.5			1.7

Year	Banks Licensed but Later Suspended	Deposits (in Millions)	Non-licensed Banks in Liquidation or Receivership	Deposits (in Millions)
1933 (10 mos.)....	168	$125.8	591	$281
1934............	56	36.9	506	196
1935............	30	4.7	47	14
1936............	43	10 8		
1937......	53	10 6		
1938 (2 mos.).....	15	5.0		

member banks failed during this period. For 1116 bank failures form a heavy casualty list for a System which aims to provide

safety for depositors; and the failure of these member banks tied up deposits running into billions of dollars. We may well ask how it happened that so many member banks failed. The answer is that the causes were many and various, running all the way from the use of funds to construct a modern replica of a Greek temple as the bank's place of business, to the "borrowing" of large sums by bank officials (sometimes without even the formality of giving a promissory note) and the loss of these funds in playing the stock market. However, the causes of many member bank failures were to be found in changes which took place in the nature of the loans and investments handled by these banks between 1921 and 1929. The figures in Table 6 will help to make these changes clear.

As may be seen from this table, one type of loan seems to have been slighted during this period of rapidly expanding loans and investments. "All other loans," which include all ordinary commercial loans to business men based upon short-term, self-liquidating

TABLE 6.—LOANS AND INVESTMENTS OF ALL MEMBER BANKS, 1921–1929[a]

(All figures in millions)

Year (June 30)	Investments	Loans on Securities	Loans on Real Estate	All Other Loans	Total Loans and Investments
1921	$ 6,002	$ 4,400	$ 875	$12,844	$24,121
1922	7,017	4,500	1,100	11,565	24,182
1923	7,757	4,950	1,350	12,450	26,507
1924	7,963	5,350	1,575	12,279	27,167
1925	8,863	6,718	1,875	12,062	29,518
1926	9,123	7,321	2,161	12,579	31,184
1927	9,818	8,156	2,449	12,333	32,756
1928	10,758	9,068	2,624	12,611	35,061
1929	10,052	10,095	2,750	12,814	35,711
Percentage increase, 1921–1929	67	129	214	0	48

[a] Source: *Hearings, S. Res. 71, 71st Congress, 3rd Session*, p. 138, as reported by Lawrence W. Towle in his article, "Time Deposits and Price Stability," in *American Economic Review* for December, 1935, pp. 653–660.

paper arising out of the exchange of commodities, remained virtually constant during the period. It may be that the speeding-up of delivery services made it possible for some business men to reduce their inventory requirements and adopt the policy of so-

called hand-to-mouth buying; and perhaps other firms were reluctant to become heavily indebted to commercial banks while the bitter experiences of the 1921-22 depression were still fresh in their minds. Then, too, as the period wore on, it is possible that their own large profits provided many business men with an adequate supply of funds and that "favorable" stock market conditions induced some corporations to obtain, by the sale of additional shares of stock, funds which would ordinarily have been borrowed from the banks. Whatever the specific causes may have been, it is an undeniable fact that, despite a 48-per-cent increase in total loans and investments, the member banks were performing their principal function of providing short-term *business* credit no more briskly at the end of the period than at the beginning.

But during this period large additions were made to the gold stocks of the country, bank reserves were plentiful, and the Federal Reserve System, for various reasons, quite consistently followed an "easy money" policy. Since banking is not a profitable business unless bank funds are kept at work, the member banks, in the absence of appeals for ordinary commercial loans, decided to lend in other fields. The identity of these fields may be readily established by reference to Table 6. From 1921 to 1929, member banks increased their loans on real estate by 214 per cent, their loans on stocks and bonds by 129 per cent, and their direct security purchases and other investments by 67 per cent. As a result of these changes, many member banks found themselves by 1929 in a position which raised doubts as to their soundness as commercial banks.

The Question of Frozen Assets.—We are not suggesting that loans should not be made on real estate and securities, or that banks should not invest in securities. Such loans are necessary and desirable, but we question that commercial banks are the best institutions to handle these kinds of business. When, during a boom period in business, commercial banks get the greater part of their assets tied up in real estate and securities, despite the fact that their depositors have the right to demand their deposits in cash either immediately or on a few days' notice, they are likely to find themselves in trouble if prosperity gives way to depression. For example, the depression years of 1929 to 1933 were marked by falling prices of securities and real estate, and many member banks were unable to recover the funds which they had lent or invested.

Of course, the member banks' "call loans" to brokers, secured by stocks and bonds, were safe; and loans to other customers, advanced to buy securities, probably led to few losses when these loans were made on adequate "margin." For if the customers failed to pay their indebtedness, the banks could usually sell the securities for enough to cover the loans. However, some losses were doubtless taken on loans of this type, when bankers had imprudently lent too high a percentage of the inflated values of securities—for the slump in security prices was sudden and drastic. In many cases, the loans on real estate, which had seemed very conservative on the basis of the inflated valuation of the properties, were found to be uncollectible, for the depression prices of many parcels of real estate were less than the amounts that had been lent on them. Similarly, the banks' directly owned securities and other investments declined rapidly in value, and the efforts of distressed banks to liquidate these investments speeded the decline. Consequently, when depositors began to demand their deposits, member banks found themselves in serious difficulties.

But were not the Reserve banks expected, in such troublous times, to come to the rescue of their members? It was, indeed, a time when aid was needed, but the member banks were often not in a position to claim and receive aid. For membership in the Federal Reserve System was never an absolute guaranty of safety for a bank. The statement that the System would not allow member banks to fail meant merely that the Reserve banks would place funds, in practically unlimited amounts, at the disposal of member banks which had not impaired their borrowing power through dishonest or imprudent banking practices, and which had on hand a supply of collateral eligible for rediscounting. The Reserve banks could advance funds to members (1) by rediscounting eligible commercial paper, and (2) by discounting promissory notes of the member banks themselves, when secured by government bonds.

However, eligible commercial paper and government bonds are likely to be scarce in the case of banks that have lent extensively on other types of collateral. The Reserve banks could not legally rediscount paper based on stocks and bonds, or real estate mortgages; nor could they lend on the member banks' direct investments, unless these took the form of government bonds. So far as we know, no member bank failed during the depression because the Reserve banks were short of funds, but many failed because their assets were such that the Reserve banks could not legally aid

them. And it developed that some member banks were signing their own death warrants when they overexpanded certain types of loans and investments from 1921 to 1929, though at the time they seemed merely to be sharing in what many people regarded as a new and permanent era of prosperity.

The Attitude of the Public.—It would be both unfair and misleading to say that every member bank that failed richly deserved to do so. The banks that took improperly secured mortgages, and unseasoned, high-yield, narrow-market bonds, or that made loans on securities which were inadequately margined, inadequately diversified, or which otherwise failed to measure up to sound banking standards, were responsible for their own fate.[1] Moreover, the conditions were even less satisfactory in nonmember banks. However, some banks failed, or were at least seriously embarrassed, because of hysteria on the part of the banking public, and not because they were unsafe. Some banks that had been reasonably prudent were forced to close their doors because unreasoning fear on the part of their depositors led them to demand immediate cash for their deposits. And in some cases these demands could not be met because the banks had, in all good faith, accepted commercial paper which proved later to be worthless, since the firms that issued it had been forced into bankruptcy by the depression. It would seem, then, that a banking system is not much stronger than its weakest bank. Had not the failure of certain large banks disclosed the existence of unsound conditions in the banking world, the depositors of other banks might not have questioned the safety of their deposits, and thus runs on essentially sound banks might have been avoided.

Recent Legislative Changes Affecting Safety: Separation of Commercial and Investment Banking.—In view of the general criticism of our commercial banking system in recent years, it was inevitable that legislative steps should be taken to remedy the situation. Let us examine this legislation, considering first the measures taken to separate investment and commercial banking.

The Banking Act of 1933 provided that member banks must give up their security affiliates within one year. These affiliates were companies organized and controlled by commercial banks

[1] So said Winthrop W. Aldrich, noted New York banker, in suggesting ways of improving the banking system, before the Sub-Committee of the United States Senate Committee on Banking and Currency at Washington, November 29, 1933.

for the purpose of engaging in investment banking operations. These operations, which had proved profitable prior to 1929, could not legally be performed directly by member banks. Though the relations of commercial banks with their security affiliates were often entirely wholesome and aboveboard, there were cases in which the reverse was true. The affiliates sometimes unloaded doubtful securities on the commercial banks—securities which the banks would not have purchased from anyone else—and the banks sometimes made loans to their affiliates in amounts and on securities which would not have been considered by the directors of independent banks. Hence, the separation of the two types of banking was probably necessary, if we are to have a sound commercial banking system. It was also provided that investment bankers shall not be allowed to hold demand deposits, and that no officer or director of a member bank shall be an officer or director of an investment banking firm.

We must also emphasize, at this point, the fact that the Board of Governors of the System has authority to regulate the percentage of member banks' capital and surplus which may be tied up in security loans, and may deny rediscounting facilities to member banks which misbehave in this respect. Formerly, the Reserve banks were required to rediscount for member banks whenever eligible paper was presented, and the member banks could use the funds for speculative or other purposes. Member banks are now prohibited from making call loans "for others"—the others being individuals, corporations, or foreign groups who wish their funds to be used temporarily for speculative purposes with the privilege of withdrawing them at any time. Member banks may not underwrite securities, may deal in securities only as agents of their customers, and may not have more than 10 per cent of their own capital and surplus invested in the securities of any one obligor.

Loans to Officers.—One of the evils of our banking system in the past was borrowing by executive officers from their own banks on collateral of doubtful value. The Act of 1933 provides that officers of member banks may not borrow from their own banks and must report any personal loans from other banks. However, according to the Act of 1935, banks may lend to officers of member banks in amounts up to $2500, provided the loans have received the prior approval of a majority of the directors of the lending banks.

These regulations are probably desirable and, if they have the

effect of keeping member banks within their legitimate field of commercial banking, may add to the safety of their depositors. However, it must be remembered that the effect of such legislation, with respect to both elasticity and safety, may be offset in part by the non-member banks, which are not controlled by federal legislation. Moreover, there may be other ways to render the regulations ineffective. For example, prior to 1933, a business man who wished to play the stock market might leave his own funds in his business as capital and speculate with borrowed funds. Now, however, he might speculate with his own funds and borrow from a commercial bank to finance the short-time needs of his business. In such cases, the banks' safety may be increased, but speculation is not controlled.

Changes in the Rediscounting Privilege.—The Banking Acts of 1933 and 1935 also changed the terms on which member banks may borrow from Reserve banks, and provided a system of federal deposit insurance for bank depositors. During the depression, depositors were sometimes unable to get cash on demand, because of the inability of the banks to turn their assets into cash promptly. The obvious remedy was to make all kinds of commercial paper eligible for rediscount at the Federal Reserve banks. The new law did not do this, but it did something almost as unwise, for it provided that member banks may borrow from Reserve banks on their own promissory notes, secured in any way satisfactory to the Reserve banks. These loans may be made for four months or less at a rate of interest only one-half of one per cent higher than the highest rediscount rate in effect at the Reserve banks. This means that, while only eligible paper may be rediscounted, member banks may, in effect, turn their ineligible paper and other assets into cash at Reserve banks and may thus be protected from the logical results of their unsound policies in lending on real estate and securities, and investing directly in securities. This policy may give greater safety to depositors, but it is extremely doubtful that it will raise the standards of commercial banking.

Loans on Real Estate.—The Act of 1935, following logically the mistake noted above, lowered the restrictions on real estate loans of member banks. These loans could formerly be made up to a total amount of 25 per cent of a bank's unimpaired capital and surplus, or 50 per cent of its deposits, whichever might be greater, while the new limit is 100 per cent of capital and surplus or 60 per cent of deposits, whichever is greater. The individual

loans could formerly be made only up to 50 per cent of the value of the real estate and for five years or less. Now they may be made for ten years and up to 60 per cent of the appraised value, provided 40 per cent of the principal of the loan is paid in installments over the ten-year period. Moreover, such loans are renewable.

These new provisions relating to borrowing by member banks from Reserve banks and to real estate loans appear to us to be objectionable, though they have been hailed with evident delight by some writers on banking. These writers hold that investments and loans on real estate and securities have become an increasingly important part of the commercial banks' business in recent years and that, under the circumstances, it is silly to deny the banks access to the reserves of the System merely because they cannot supply the prescribed eligible commercial paper. If depositors are to be safe, the banks must be able to convert other assets into cash at the Reserve banks in an emergency. This is comparable to saying that commercial bankers must be allowed to wander into fields where they do not belong, but that the Reserve System must protect them against getting into trouble during their wanderings and thus causing loss to others. If the premise is granted, the conclusion seems to follow; but we suggest rather that an attempt should be made to keep commercial banks strictly within the field of commercial banking, and thus prevent the mistakes which are largely responsible for the losses suffered by depositors. If commercial bankers will only run their businesses as they should, they may obtain adequate assistance from the Federal Reserve System in time of need, under the old provisions for rediscounting.

The Plan for Deposit Insurance.—But if banks fail in spite of all that is done for them, the Act of 1935 has yet another safeguard for the depositors—for the Act provides for federal insurance of bank deposits through the Federal Deposit Insurance Corporation (hereafter referred to as the F.D.I.C.), whose original capital was furnished by the government and the Federal Reserve banks. All banks which were insured under a temporary plan provided by the Act of 1933 may continue to be insured. Member banks are now required to take out deposit insurance, and an insured non-member bank must join the Federal Reserve System by 1942 if it has deposits totaling $1,000,000 or more. Smaller outside banks may participate without becoming member banks. Non-member banks not now insured may be granted

insurance after passing an examination. The assets of such banks must exceed the capital by an amount sufficient to meet all liabilities. New national banks and state member banks must qualify for insurance before receiving their charters. The F.D.I.C. may deny insurance to any bank it considers unsound or unnecessary, and banks may withdraw from the insurance system at will, or may be excluded for violation of the rules.

The F.D.I.C. provides insurance for each depositor of an insured bank up to $5000. Persons having larger funds may secure full coverage by depositing with several banks. About 98.5 per cent of all depositors' accounts, by number, are fully protected despite the seemingly low limit of $5000. For this deposit insurance, the banks pay a premium of 1/12 of one per cent per annum on total net deposits. If an insured bank fails, the F.D.I.C. may act as receiver and take care of its depositors by giving them deposits in a new bank organized for the purpose, or may pay them off in any other manner. It would be most economical for the F.D.I.C. to organize a new bank, since most of the distressed bank's depositors would probably leave their funds on deposit in the new bank, instead of withdrawing them.

Evaluation of Deposit Insurance.—Many arguments have been advanced in favor of deposit insurance. It is said to be costless to the banks themselves. The argument is that the banks lose heavily whenever business men and other depositors lose their confidence in them, as they do after a period of bank failures, so that to buy insurance is cheaper than not to have it. It is believed that deposit insurance will stimulate the growth of savings deposits and prevent hoarding, and will aid in protecting sound banks against the runs which are common when weak banks fail. Finally, attention is frequently called to the helplessness of the depositors, in the absence of insurance; to the inadequacy of the protection which they receive through governmental supervision and examination of banks; to the public character of banking; and to its great importance in our national economic life, which makes it imperative to avoid bank panics if it is at all possible to do so.

Against deposit insurance, it is often argued that, from a technical point of view, it may be unwise to provide insurance at a flat premium for all banks without regard to the risk involved. In other types of insurance, the principle employed is to vary premiums as between classes or individuals, according to the degrees of risk represented. Moreover, a flat premium rate based

on total deposits discriminates in favor of the small banks. For a small bank may get practically complete coverage of its deposits by paying the flat premium on total deposits, while a large bank with many deposits over $5000 may have only a fraction of its total deposits covered by insurance although it pays a premium based on total deposits.

Furthermore, it may be questioned that bank deposits are genuinely insurable. Our experience in the post-1929 depression showed that a considerable number of banks may get into trouble at one time, and if this should happen in the future the F.D.I.C. might become insolvent. It is argued that a risk, to be really insurable, must be one which will not result unfavorably for many or most of the insured at any given time. Fire insurance companies would hesitate to grant insurance if there were any likelihood that all or most of the insured properties would be destroyed by fire at any one time. A popular answer to this objection is that depositors will no longer take part in runs on banks, since they know that the government stands behind the deposits, but this answer is not wholly convincing. In spite of the protection provided by insurance, the deposits in a bank that fails might not be available for depositors the next day, or even the next week. Some little time, and possibly several months, might elapse before all depositors would be paid. Since this is true, the desire to have one's money now rather than later might lead to bank runs as in the past, and cause the F.D.I.C. real embarrassment. If necessary, the government would doubtless provide the Corporation with additional funds to prevent its failure; but if the need for such governmental aid should develop, the "insurance" of deposits, as such, would appear to be unsound. It is entirely possible that bank deposits could be handled through the application of the accepted principles of insurance, by carefully selecting the banks whose deposits are to be insured and charging adequate premiums. But it is open to question that our wide-open, flat-rate system of so-called deposit insurance is either desirable or safe.

Deposit insurance—especially insurance on a flat-rate basis—may be objected to, also, on the ground that it might encourage recklessness on the part of some bankers, since they know that, because of the insurance, their actions will not cause loss to their depositors. However, the situation in this respect is by no means so hopeless as might appear on the surface. The F.D.I.C. has rather extensive powers of supervision and examination over all insured

banks, and represents the first extension of federal power over non-member banks. Banks may be expelled from the insurance system for cause, or may be asked to merge if insurance is to be continued. The F.D.I.C. has power to regulate the rate of interest paid by insured banks on time deposits, and banks are no longer permitted to pay interest on demand deposits. Finally, it is expected that the operation of deposit insurance will deter would-be bankers from starting unsound and unnecessary banks, since such banks would be refused insurance and few people will care to intrust their deposits to banks that do not carry deposit insurance.

Quite apart from these criticisms, it is appropriate to ask whether deposit insurance of some kind is or is not a necessary and desirable adjunct of a sound system of commercial banking. Our answer is in the negative, and the basis of this answer is a familiar one. If we were to assume that commercial bankers through unsound banking practices would continue, in the future as in the past, to get into difficulties which would result in serious loss to their depositors, then we should be inclined to indorse federal deposit insurance. But we object to this assumption, since we contend that the depositors in a soundly conducted system of commercial banking would be adequately protected, in general, without recourse to government assistance in this form. Hence, we cannot regard deposit insurance as the best possible method of safeguarding the interests of depositors.

THE NEED FOR FURTHER CHANGES

It should be clear, from our discussion thus far, that the problems of commercial banking have not all been solved, by any manner of means. Specifically, at least two important problems remain. The first is whether we can hope for controlled elasticity, and safety for depositors, so long as we have a separate system of commercial banking for each state, side by side with the Federal Reserve System for member banks all over the country. With forty-eight state banking systems, each operating under its own banking laws, and with the state-chartered banks largely beyond the reach of federal control, effective regulation of commercial banking as a whole seems impossible of achievement. The second problem is whether, regardless of the organization of the banking system, our commercial banks can provide safety for depositors so long as these banks have the power to create demand deposits on the basis of fractional reserves. As long as banks

can expand deposits to huge proportions, when compared with the amount of money into which the deposits are supposed to be convertible upon demand, is there not some danger at least that they will be unable, in time of emergency, to pay all legitimate claims outstanding against them?

To questions such as these, the students of banking problems have given many and varying answers. Some, convinced of the impracticability and injustice of commercial banks being operated by private individuals for profit, urge that banking should be conducted as a government monopoly. They would have one Bank of the United States, with as many branches as might be necessary, and with full control (albeit political control) over elasticity and safety. Others feel that the actual business of dealing in commercial credit should be left to private bankers, but that the government should control the total amount of credit and assure safety for the depositors by keeping on hand an amount of money as large as the total of deposits. These proposals are interesting now, and may be important in the future. It appears probable, however, that most Americans would favor a final attempt to make our commercial banking system genuinely workable, before deciding that it must be taken out of private hands and completely socialized. We continue, therefore, our discussion of possible changes in commercial banking under private ownership.

Branch Banking.—Many economists feel that our commercial banking problems could be solved, while leaving the banks in private hands, by adopting a system of branch banking. In such a system there would be, say, ten or twenty large banks in the United States, each with hundreds of branches, and the small independent banks, of which we have some 16,000 at present, would be eliminated. Supporters of branch banking contend that such a system would go far toward removing the causes of bank failures. In the first place, a large bank with many branches could have a widespread industrial and geographical diversification of assets and liabilities, which would prevent its being forced into bankruptcy by local factors affecting certain types of loans, while its size would make it possible to bear heavy losses without becoming insolvent. Many of our recent bank failures have been those of banks with very small capital which have been unable to diversify their loans properly and have become insolvent when their principal form of loans turned out badly. Under branch banking, it is claimed, such loans could safely be made by the

branches, because these loans would be combined with many other types of loans and the parent institutions would be so large that whatever losses occurred could be absorbed without serious difficulty.

A second reason for expecting a reduction in bank failures is that branch banking would probably provide what are now our smaller banks with a superior type of bank management. The great size of the parent banks would make it possible to employ the best of management, and all branches would benefit by this high-class managerial ability. In addition, it might be possible to require bankers to be carefully and completely trained before they were placed in positions of responsibility.

It seems unlikely that branch banking would bring any appreciable change in the ability of money and credit to expand and contract. However, the control of elasticity might be somewhat more effective under branch banking than under our present system. It might be easier to induce a few large banks to cooperate in the control of credit than to get cooperation from thousands of more or less independent banks; and, furthermore, the enforcement of banking laws and regulations might be simplified under branch banking. Of course, the problem of proper examination of the banks and their branches would still be a formidable one.

Disadvantages of Branch Banking.—In our opinion, however, branch banking would be unlikely to bring all of the advantages that are claimed for it, and might indeed give rise to new problems. The possible advantages which we have listed above would certainly not come about automatically. A large bank with many branches could diversify its loans and investments to a greater extent than ordinary independent banks, but whether it would actually do so would depend upon the management. Moreover, mere size is by no means a positive guaranty of safety. A branch banking system in which management is no better than the average management of American banks in the past might be no safer than the present system. Countries with branch banking have had failures of banks with hundreds of branches, though in general the record of such countries during the great depression was excellent. Of course, parent banks in America might be so large that the government could not afford to let them fail; but this type of safety would represent no advance over the

present situation, for we have already decided that we cannot leave our independent banks free to fail.

The greater safety of banking systems in other countries has probably been due less to branch banking than to better management than we have enjoyed, coupled with a stricter adherence to sound principles of commercial banking, and the operation of all banks under a unified banking system and uniform laws. In Canada, for example, all commercial banks operate under a set of laws applying to the whole Dominion. Canadian commercial banks do not lend on real estate or engage in handling trust funds. They may not hold shares of bank stock, or make loans with such stocks as security. Their investments consist almost wholly of high-grade bonds or other securities which are quickly convertible into cash. Nor do they follow the common American practice of renewing a given short-term loan over and over again, until it amounts virtually to a fixed capital investment. Finally, the managers of Canadian banks are generally steeped in the traditions of sound commercial banking, and have often risen from the ranks on the basis of merit alone. If we could develop some of these desirable elements in our present banking system, we could doubtless get along very well without branch banking.

We may note several of the new problems which might accompany the introduction of branch banking. A higher type of management might be offset to some extent by the heavy cost of the central organization, the red tape involved in its operation, delays in making decisions, and an extensive division of responsibility. A system of branch banking might retard the economic development of the country. Small depositors and borrowers might be neglected because of the greater profitability of large accounts and the inability of small borrowers to furnish collateral security acceptable under the rules of the parent bank. Branch banks might find it difficult to adapt themselves to changing economic conditions. Large institutions often depend extensively upon formal rules and regulations in operating their business, and branch banking might result in a relative fixity of policy which would lessen the ability of the banking system to adapt itself to the varying needs of different sections of the country.

Finally, it is sometimes contended that branch banking might lead to a concentration of power which we would find intolerable. Those in control of the few great banks might come into control of industry, and dominate fiscal and Federal Reserve policies as

well. Since the branch banks would be operated for profit, such a financial monopoly might adjust the issuance of commercial credit to the needs of the country even less successfully than our banking system has done in the past, and conceivably create a situation in which the banks would be safe only because of their ultimate reliance upon the credit of the government.

Compulsory Membership in the Federal Reserve System.—It may be best, then, to seek the benefits that have been associated with branch banking in other countries, without whole-heartedly adopting branch banking itself. For one thing, we should refuse to permit the continuance of forty-nine separate commercial banking systems in the continental United States, not counting the District of Columbia. The clumsiness of this structure and its weakness in connection with adequate credit control and the maintenance of safety are obvious. We suggest that the starting point of genuine reform is to require every commercial bank in the United States to join the Federal Reserve System. This requirement would promptly bring all commercial banks under one general plan, with the result that our national banking laws and regulations relating to elasticity, credit control, the relations of commercial and investment banking, and safety, would function much more effectively than in the past.

It is important that this measure be enforced without any lowering of requirements, especially with regard to minimum capitalization for member banks. Indeed, it would probably be well to raise the minimum capitalization to a figure considerably above the present requirement. It may be objected that some state banks could not make the changes necessary to meet the requirements for membership in the Federal Reserve System. This is probably true; but the objection may be answered by saying that any bank which, given due notice, fails to measure up to the membership requirements is not an essential part of our commercial banking system and may well be eliminated.

The Restriction of Commercial Banking.—With all commercial banks operating as members of the Federal Reserve System, the present laws and regulations concerning credit control might be quite adequate for the purposes for which they were intended. Our laws relating to the separation of commercial and investment banking houses are also satisfactory as far as they go. We believe, however, that commercial banks should be forbidden to lend on real estate, for this is not properly a function of com-

mercial banking. Loans on stocks and bonds should be permitted but sparingly, and then only with large margins of safety. The security investments of banks should be limited to the highest and most liquid types of securities. Unless our commercial banks can learn to run their savings departments without becoming confused as to function, it would seem desirable for commercial and savings banks to be entirely separate institutions. This comment is applicable also to trust departments now operated by commercial banks. The banks' power to make fixed capital loans to business men, by the device of renewing short-term loans over and over again, should also be limited sharply.

Under conditions such as these, there would probably be little need for deposit insurance, or for member banks to borrow from Reserve banks on the basis of so many types of security. We should no longer be troubled by an extension of deposit credit to many times the amount of money available for the conversion of deposits into cash. If the deposits of commercial banks were almost entirely the result of bringing cash items to the banks or discounting eligible commercial paper, there would be no need to have on hand, in the form of money, 100 per cent of the deposits which might have to be paid off at any time. That is, if the banks' deposits were backed almost wholly by liquid investments and by commercial paper eligible for rediscount, the banks could always secure cash at the Federal Reserve banks in quantities sufficient to stave off any run by depositors; and we should not need to liberalize the conditions for rediscounting or provide deposit insurance. The deposits of a *sound* commercial banking system are safe without outside guaranty.

The Development of Better Bankers.—But we need in this country not merely a reform of banking laws but a reform of bankers as well. Many an authority on banking, wearied by the adoption of many banking laws which appear to bring little improvement, has suggested that our commercial banking system has been overburdened with legislation but insufficiently governed by sound credit policies and practices on the part of the bankers. The American attitude toward banking problems has been that, if we could pass large numbers of good laws, we should get good banking; but actual experience gives ample grounds for suspecting that it is difficult, if not impossible, to make good bankers by legislation. We have tried by law to prevent banking practices

which bankers in other countries, under the influence of tradition and custom, would regard as unthinkable.

No body of banking laws can be so nearly perfect that bankers cannot, if they wish, find loopholes for employing methods which may eventually have serious consequences to their own businesses and to many members of society. There is no adequate substitute for the sound judgment of bank officers as a safeguard against the improper use of credit; and it seems clear from past experience that an improvement in banking personnel must be an integral part of any advance in commercial banking. There is need for an understanding of the relation of commercial credit to the rest of our economic structure, and an appreciation of the fact that a loan may be sound and profitable in and of itself and yet, in conjunction with thousands of similar loans by other banks, disastrous for the system as a whole. It is said to be a custom in a certain European country for the head of a wrecked bank to take his own life, instead of hiring a battery of lawyers to defend him or departing posthaste for foreign and sunnier climes. Without going so far as to advocate such harsh measures, we are firmly convinced that our bankers must be made to recognize their obligations—that they must be brought to regard banking as a kind of public trust instead of, or at least as well as, a business conducted for private profit.

Investment Banking

Investment credit, as we have seen, consists of long-time loans of large amounts, and is used for the purchase of fixed capital. The demand for investment funds comes from three chief sources: (1) The needs of business enterprises; (2) the needs of the various governmental units; and (3) the purchase and improvement of real estate. The security issues of corporations and governments are marketed principally through investment banks. The securities handled consist, at present, of stocks, bonds, and short-term obligations. Strictly speaking, of course, stocks do not represent loans to corporations, but are instead evidences of part ownership in businesses. However, so far as marketing methods are concerned, and in connection with the principal issues underlying the problem of investment banking, stocks and bonds can be considered together.

The Functions of Investment Banks.—Investment banks do not themselves furnish investment credit or capital for long-time

uses. They are really only the initial providers of funds for investment purposes; that is, they are middlemen between those organizations that wish to obtain funds for long-time uses and the individuals who ultimately furnish such funds. The funds are provided, in the last analysis, by individual investors and by organizations such as savings and commercial banks, insurance companies, and corporations, which have accumulations of individuals' funds to invest. In serving as go-betweens in the process of providing investment credit, the investment banks perform three main functions: (1) Investigation and analysis; (2) underwriting; and (3) distribution.

Investigation and Analysis.—This function is performed by a relatively small number of large investment houses, principally for the reason that the next step, underwriting, often requires very large financial resources. The need for investigation and analysis arises whenever a corporation (or other issuing body) requests the help of an investment banker in disposing of a prospective issue of securities. The investment bank must decide in each case whether the proposed issue is sound, and, if so, must set a price for taking over the securities which will be acceptable to the corporation and will afford the bankers an opportunity for profit on the transaction. In performing the function of investigation and analysis, a great many factors must be taken into consideration by the investment banker. Among them are such things as the profits of the concern or concerns in question, the relation of assets to liabilities, the physical property possessed, the nature of the specific security under consideration, and the conditions at present existing and likely to exist in the investment market.[2] If it is decided that the proposed issue of securities is sound and a price satisfactory to all concerned can be agreed upon, the next function, that of underwriting, may be entered upon.

Underwriting.—The term "underwriting" signifies the sharing among several investment houses of the risks involved in marketing an issue of securities. This process assures the corporation the possession of the funds desired at the time they are needed. Underwriting takes place whenever an investment house agrees to put out an issue of securities which is too large for it to handle alone. The issuing corporation is guaranteed the proceeds of the issue of securities, at the price agreed upon, at some definite future

[2] H G. Moulton, *The Financial Organization of Society*, Chicago, University of Chicago Press, 3rd ed., 1930, p. 201.

time, and the investment house which has done the preliminary work invites other houses to share in the responsibility of furnishing the funds. If it is possible to dispose of the issue to investors before the date on which the funds must be given to the corporation, then all that remains to do is for each participating house to receive its share in the payments for underwriting and distributing the securities. Whether or not the issue meets with favor and is entirely sold by the time at which the corporation is to be paid, each house is held responsible for its share of the securities as agreed upon, and must furnish a like share of the funds for the corporation.

Distribution.—The function of distribution means, of course, the ultimate sale of the issue of securities. The number of concerns taking part in distribution is usually much larger than the number that participates in the underwriting. Many bankers, small dealers, and brokers assist in the final marketing, though they are not equipped to perform the function of investment and analysis or to share in the function of underwriting. A part of the risk of marketing the securities is often borne by these dealers, because they are not usually allowed to return any part of the securities which they undertake to sell for the larger underwriting houses. At times the process of distribution is a long-drawn-out affair and involves heavy cost.

PROBLEMS OF INVESTMENT BANKING

Many problems of individual and social significance have arisen in connection with investment banking. One is the necessity of providing the greatest possible degree of safety for purchasers of the securities issued by investment banks. Investors must be protected from securities that are fraudulent in character, and from security salesmen who grossly overstate the possibilities of the stocks and bonds they offer to the public.

Another chief problem is to insure that investment banking shall be carried on efficiently and in a manner consistent with the public welfare. More specifically, this means that investment credit must not be so extended at certain times and so restricted at others that its issuance becomes an important cumulative factor in causing business instability. It means, also, that this credit must be distributed among the industries seeking it, so as to coordinate the creation of new productive facilities with the desires of consumers. Finally, it is important that investment banks, in perform-

ing their function, shall not be permitted to get a strangle-hold on industry by threatening to withhold needed credit if such control should be denied them.

Safety for Investors.—Those who have securities to sell are frequently more optimistic as to the future of their stocks and bonds than the situation warrants. Consequently, many of the securities sold to the public have turned out to be worthless. This failure of securities to live up to the representations of the sellers is by no means a new economic phenomenon. Indeed, it is as old as the corporation itself. The fleecing of the public through the sale of worthless securities has led to the adoption, by nineteen of our forty-eight states, of laws regulating the sale of securities and providing for the recovery of losses incurred by those to whom they have been sold in violation of law.

But the widespread purchase of stocks and bonds in the boom period preceding 1929, followed by the loss of some twenty-five billion dollars by the American purchasers of valueless securities, brought the question of investment frauds to a head. The result was the passage of two federal measures, the Federal Securities Act and the Securities Exchange Act.

The Federal Securities Act.—The Federal Securities Act was passed in 1933. Its purpose was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof"

Without intending to interfere in any way with the enforcement of state legislation dealing with the sale of securities, this federal law was designed to insure that the buyer of stocks and bonds should be fully informed as to the standing of the company in which he was investing. The issuer of a security was required to file with the Securities and Exchange Commission (a commission of seven members appointed by the President of the United States) a registration statement which contained all information about the security and its issuer which an investor needed to know. Until this statement was filed, the security could not be sold or offered for sale through any agency of transportation or communication in interstate commerce or through the mails. Once the statement was filed, the seller had to provide every buyer with a prospectus, which in reality was a summary of the information contained in the registration statement.

The Act also provided for the civil liability of security issuers

to investors suffering losses, if the registration statement or prospectus contained false information or omitted material facts. All who shared in misleading the investors, including the issuing corporation, the original investment bank marketing the security, the underwriters, and even accountants and other experts, were held liable. As originally passed, the liability provisions were very severe. Purchasers of securities could recover in court their full losses on the securities, even though the false information or omissions in the registration statement or prospectus were not the cause of the loss, or were only a partial cause. The Act permitted recovery of losses by anyone buying a security, whether or not he ever saw or relied upon the statement containing the false information or omission. Each member of an underwriting syndicate was held liable to all purchasers of a security, including the customers of other members of the syndicate as well as its own customers, and suit could be brought for the recovery of losses at any time within ten years after the public offering of the security.

Appraisal of the Federal Securities Act.—The Federal Securities Act aroused a good deal of protest. There was general sympathy with the aims and purposes of the Act, but it was felt that the law was unduly severe in prescribing liability for security issuers and sellers. It was held that the Act assumed guilt on the part of all connected with unfortunate security issues unless they could prove their innocence, and that it would foster litigation, false claims, and nuisance suits. It was pointed out that not all information connected with a business could be furnished to the Commission and that a fact, originally omitted from the registration statement as unimportant, might later appear to be material and relevant. Some critics even expressed a fear that the investment banking business might be practically exterminated because of the great dangers and liabilities that would have to be borne by corporations, investment bankers, and underwriters.

As a result of those protests, the Federal Securities Act was amended in several respects in 1934. The purchasers of new securities may now recover full losses, without regard to causation, unless the defendant can establish that the loss was not caused, or was only partly caused, by the false information or omissions of the registration statements or prospectus. If a person buys a security before the publication of the first twelve-months' earnings statement of the issuing corporation after the date of registration, it is assumed that he relied upon the information in the registration

statement or prospectus. If the security is purchased later, reliance on the information must be proved. No member of an underwriting syndicate is now liable for an amount in excess of the aggregate price of his share of a security issue, and a suit to recover a loss must be brought within three years after the public offering of the securities.

It is difficult to say just what effect the Securities Act has had on the volume of new security issues. To be sure, the investment banking business has not been thriving greatly since the enactment of the law—nor did it thrive for several years prior to the passage of this legislation—and many opponents of the Act have attributed the small volume of business to a fear of the consequences of enforcement. But this theory does not account for the decline in railroad and municipal financing, since these fields do not come under the provisions of the Act. Moreover, there are other and more plausible explanations of the decline. It is possible that investment bankers have to some extent been "on strike," in an effort to make the law appear unworkable. Many industries had already overdeveloped their productive capacities and would not have been in the market for new financing in any case, while the officials of some corporations doubtless decided that their credit had deteriorated and were not anxious to assume the burden of further fixed charges. Monetary uncertainties and the lack of savings clamoring for investment may have been other factors entering into the situation.

In general, there seems to be little reason why the Act, as amended, should unduly restrain the legitimate issuance of investment credit. If well administered, it should be of considerable aid in providing safety for investors. The people in the investment banking field still think the regulations too severe, but this is almost invariably the case when a business is first brought under federal regulation. However, further provisions of the Act may eventually require amendment. It is contended that the information which corporations must now supply is unreasonably voluminous. It would seem that adequate information could be obtained without a corporation having to furnish, as in some past cases, enough facts to fill ten to fifteen large bound volumes at an expense to the corporation of from $150,000 to $200,000. It is probable that suits under the Act should be heard only in the federal courts, and not in state courts as well. Finally, small underwriters should perhaps be allowed to rely on the statements of large investment

houses, since it would be difficult for the small firms to insure that the data given for registration statement and prospectus are full and accurate.

The Securities Exchange Act.—The Federal Securities Act was not adequate to protect all investors, however, for two reasons. First, it applied only to new security issues, and many investors lost their all by purchasing securities already existing on the exchanges. In the second place, while most bonds are publicly offered, many new issues of stock were formerly distributed through the security exchanges, often by a variety of manipulative devices. For example, when an issue of stock was to be distributed, the first step was to register it, say on the New York Stock Exchange. Then the owners of the issue would make it appear active on the exchange, by hiring brokers both to buy and to sell the issue for the account of the owners. For a time they might have to buy more than they sold, so that the price of the stock would show a steady rise. But eventually the public, attracted by the activity and price rise of the stock, would come into the market; and then the brokers, by selling more shares than they bought, could distribute the issue at the artificially high price.

The Securities Exchange Act, passed in 1934, aims to discourage such practices. It requires all securities exchanges, unless exempted by the Securities and Exchange Commission, to be licensed by the Commission after furnishing certain required information. Every security issue listed on the exchanges must also be registered with the Commission by the issuing corporation. The registration statements must contain facts in ten categories enumerated by the Act, in addition to any further financial statements which the Commission may deem necessary. The corporations may also be asked to file certified reports periodically. The result is that many corporations are now required to register with and furnish information to the Commission, although they would have been exempt from such obligations under the Federal Securities Act of 1933 because they have not recently attempted to issue new securities.

Control of Manipulative Practices.—The Securities Exchange Act attempts to define, or give the Commission power to define, the functions of brokers, dealers, and specialists, and forbids certain manipulative practices under penalty of $10,000 fine and two years' imprisonment, or both. Under this Act, pools which are organized to make money by forcing the prices of certain securities up or down may no longer use publicity to

advance their interests. They are prohibited from circulating false and misleading information about a security, from circulating any information, true or false, about prospective rises or falls in prices because of pool activity, and from paying anyone directly or indirectly for circulating such information. The creation of fictitious market activity is also forbidden. That is, it is now unlawful for any person, directly or indirectly, alone or with others, to effect a series of transactions in a registered security creating actual or apparent trading in such security or raising or depressing its price to induce purchase or sale by others. It is illegal to use the facilities of the exchanges, or of interstate commerce, or to use the United States mails for such purposes.

Corporate directors, officers, and stockholders who own 10 per cent or more of an issue of securities must file a statement with the Commission setting forth their holdings, and must report changes in ownership during each month. If officers and directors buy and sell the securities of their own corporations within a six-month period and make a profit, the gain belongs to the corporation and may be recovered by legal action. Moreover, these officers and directors are not allowed to make "short sales" of the stocks of their corporations, in order to profit by declines in the prices of these securities. Short-selling, as a manipulative device, is brought under the Commission's control, to be regulated as it may deem advisable. It may require exchanges and exchange members to report short sales daily, and to report the coverage of short sales. "Pegging" the price of a security, through purchases by its sellers while the security is being marketed, is tolerated only under rules and regulations to be laid down by the Commission. Finally, the Board of Governors of the Federal Reserve System is given the power to control margin requirements for borrowing on securities.

Administration of the Act.—In general, the direct regulation of stock exchange practices and activities under this Act is not particularly strict. The Act is rather vague, and its strength lies chiefly in the possibility of its wise interpretation by those who administer it. Its provisions are quite flexible, and often leave the Commission to set up its own rules and regulations on given points. If the Act is wisely and fearlessly administered, it should be of considerable benefit. The regulation of trading activities is fairly closely in line with plans which the exchanges themselves had been slowly developing. Thus far, the Commission is admitted, even

in financial circles, to have been quite reasonable and realistic in its interpretations and actions. It has left regulatory machinery in temporary form whenever it thought that additional factual material was necessary as the foundation of permanent policies, and has made clear that, within reasonable limits, the exchanges would be allowed to police themselves. It also prevented the removal of many securities from listing on the exchanges by permitting the temporary registration of securities until permanent registration could be arranged.

Opponents of the Act point out the fact that it attempts to regulate some activities that are necessarily difficult to uncover and prove. Operating as a curb on speculation, the enforcement of the Act may make the market for securities "thin" and subject to sharp price changes in certain periods. It is alleged that a market with plenty of speculative activity is necessary if the exchanges are to function as continuous markets for securities—that is, markets in which securities may be quickly converted into cash at prices that measure their values accurately. Also, inactive markets are supposed to have a restraining effect upon the issuance of new securities. However, some observers are of the opinion that sharp swings in security prices are attributable to the activities of speculators. It is very doubtful that real investors often need to buy or sell securities in large quantities on short notice, so that some of the alleged advantages of a speculative market are but slightly realized by those to whom they are popularly supposed to be of greatest benefit.

The Total Volume of Investment Credit.—While important steps have been taken in the direction of providing safety for investors, very little has been done about the other problems in the field of investment banking. One problem which must be faced in any economic system is that of the relative distribution of productive resources between (1) providing for present consumptive wants and (2) providing for the future through the production of capital goods. So long as productive methods remain the same and productive resources are scarce, we can enjoy a more abundant life in the future only at the expense of present consumption. The investment bankers play an important part in this situation, since the sale of security issues is the principal way of securing funds with which to buy fixed capital.

Unfortunately, however, the investment banking business is not stable, nor does it adjust itself easily to the changing demands

of industrial society. Rather it operates by fits and starts. In times of business prosperity, investment credit flows in a veritable flood and often gets far in advance of current savings available for investment, since commercial banks frequently lend funds to customers so that they may acquire securities on the installment plan. Such periodic overextensions of investment credit are partly responsible for building up the business booms which in turn give way to depressions. At other times, the flow of investment credit dries up until it is a mere trickle.

Of course, the investment bankers are not wholly to blame for periods of over- and under-investment, much less for business booms and depressions. Indeed, we have already seen that they are middlemen in the investment process, acting in response to the demands of business for investment credit and the demands of individuals and institutions for securities. The bankers could scarcely market securities in dangerously large quantities unless corporations wanted huge amounts of investment credit and people could be found to buy the securities at such times. And security purchasers could not indulge their wild desire to get rich quick by buying stocks and bonds unless the commercial banks lent the funds necessary to finance these purchases. However, we know that the ability of investment bankers to control the total volume of investment credit is much greater than is commonly assumed.

Those who engage in business in our modern economic system find it necessary to forecast future economic conditions, such as the probable extent of markets and the prices of certain commodities. In days of prosperity, they become unduly optimistic and overestimate future earnings. This is as true of investment bankers as of business men in general. When business is good, profits are large, security prices are mounting, and the future demand for consumption goods and the facilities for producing them seem unlimited, it is easy for investment bankers to exaggerate the need for investment credit. And, unfortunately, their mistakes may have wider and more serious repercussions than the mistakes of ordinary business men. It seems true, also, that the mistakes of investment bankers are more likely to arise from a desire for private profit than from attempts to gauge the needs of the country for productive facilities.

The Distribution of Investment Credit Among Industries.—Another problem in investment banking concerns the way in which these banks distribute investment credit among industries.

Since the quantity of funds available in our economic society is not sufficient to finance all of the undertakings in which business men would like to engage, it is obvious that some enterprisers will get the funds that they want while others go without. And since most of our industrial financing today is done through the investment banking houses, it is equally obvious that our investment bankers exercise a large degree of control over production. In a very real sense, they hold the power of life and death over a large part of the productive activities of the economic world, since they are in a position to provide the funds that a given concern needs and insure its operation, or to veto its appeal and thus seal its doom.

The best interests of society require that whatever capital funds there are shall be dispensed in such a way as to promote the most essential industries—that is, those which will contribute most to the welfare of society as a whole. But it is doubtful that this end can be attained so long as the distribution of investment credit is left in the hands of profit-seeking individuals. Investment bankers are probably, on the whole, neither better nor worse than any other group of business men. But they certainly are not particularly well equipped, *from the point of view of society's needs,* to perform the function of granting or denying funds. They are trained in detecting money-making opportunities; and in deciding which economic undertakings are to be financed they are naturally attracted to those that give promise of paying large returns. Thus, funds might be directed by profit-seeking bankers into the construction of palaces for multimillionaires, leaving none available for the building of "model apartments" for working people, even though the millionaires were already magnificently housed and the workers were living in slums.

The Domination of Industry by Investment Bankers.—Investment bankers have often required, as a condition of issuing investment credit to a corporation, that the corporation appoint on its board of directors, one or more members of the banking house, ostensibly for the purpose of insuring the safety of the security issue. This requirement appears innocent enough on the surface, but Americans in general were somewhat startled, a few years ago, to learn that one investment house in this country, together with its dependents and allies, was represented by directorships in corporations with net assets of some 74 billion dollars, or about one-fourth of the total of American corporate assets. This

power was centered in the hands of some 167 persons in the banking house, and they held 2450 interlocking directorships in corporations.[3] It is difficult to say to what extent investment bankers control the policies of corporations at present, but certainly it would be socially undesirable for this control to develop so far that a small group of private persons, acting as investment bankers, could dominate the economic activities of the country.

A Possible Solution.—If the investment banking industry refuses or is unable to conduct itself in a manner consistent with the public interest, we shall probably be required eventually to choose between further regulation on the one hand, and government ownership and operation of investment banking on the other. Further regulation is, of course, the more conservative of the alternatives. But it is by no means clear that further regulation would help greatly. It might aid in preventing the domination of industries by investment bankers, but it is doubtful that regulation could prevent the recurrence of periods of over- and under-investment, or cause the bankers to distribute investment credit in accordance with social needs. Many people contend that these problems are insoluble so long as investment banking remains in the field of free enterprise and is conducted for profit.

The socialization of investment banking would involve many changes Complete control over the issuance of investment securities would probably be vested in a government board created for the purpose. This board would presumably be appointed by the President of the United States. Its members would doubtless serve long terms, which would expire in rotation. They would be paid adequate salaries and be required to sever all private business connections. The board would control the total volume of investment credit, the distribution of investment credit among industries, and the rates of return, if any, which the securities issued would guarantee to investors.

In this way, it is claimed by some people, the problems which we have discussed would be solved. The board would regulate the total volume of investment credit in accordance with the needs of society, and would not be induced, by any considerations of profit or loss, to overexpand credit at certain times and limit it unduly at others. Its aim would be to distribute investment credit among the industries of the country so that those which needed

[3] H. W. Laidler, "Have We a Money Trust?" in *World Tomorrow,* September, 1931, pp. 282-284.

further development would be expanded, while the others would be held in check—for the members of the board would have no private reasons for preferring one industry to another. Finally, the danger of domination of the country's economic activity by a small group of private bankers would be removed.

Criticism of the Plan.—But the control of investment credit by a government board would be a large undertaking. There are those who question that the government could control so important a phase of economic life effectively, while leaving other phases to run themselves as in the past. They fear that the extension of governmental control to investment banking would inevitably result in bringing many other types of economic activity under public ownership, until finally a socialist state would be created. They point with scorn to the records of governments in business, which they contend demonstrate the inefficiency of governmental operation. They hold that the issuance of investment credit would be backward, rather than progressive, so that new industries could not develop as at present, because of the government's unwillingness to assume risks. They say that the issuance of investment credit would be involved in red tape and subject to political control, and political "pull" would be used in obtaining desired funds.

Finally, the critics doubt that the problems of investment banking could be solved in this manner. A government board, like a private individual, may be too optimistic at certain times and too pessimistic at others, so that the issuance of investment credit might be marked by large cyclical swings as in the past. The problem of determining genuine needs for credit among the various industries would still be a difficult one, and mistakes would be made by a government board as well as by private bankers. Moreover, the board might come to dominate economic activity even more completely than our present bankers, so that we would be moving from one type of domination to another and worse type, according to these critics of public ownership.

These arguments are not wholly convincing. The criticism relating to political conditions and political control may have been valid in the past and may be so even at present, but the mere mention of the words "political control" scarcely constitutes an effective argument against the government going into business. So far as solving the problems of investment banking is concerned, no one would contend that a government board would perform perfectly the task of controlling investment credit. It might issue

too much or too little credit at times, and would probably make many errors in estimating the needs of various industries for funds. However, we should at least have the consolation of knowing that these mistakes were made by representatives of society trying to adapt investment credit to social needs, rather than by private individuals seeking their own self-interest and guided only by the profit motive. And if economic activity must be at least partly controlled by the agency which issues investment credit, many people would doubtless prefer to have this control exercised by a group of men representing society as a whole, rather than by profit-seeking investment banking houses.

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1. Under what circumstances do business men need commercial credit? How may commercial banks render a service in this connection?
2. Why is there need for elasticity of credit in the banking system of the United States?
3. Why is there need for centralized control of commercial credit?
4. How was the Federal Reserve System, under the authority originally granted it, expected to control the expansion and contraction of credit? Were the powers vested in the System adequate for this purpose?
5. May we reasonably expect to eliminate cyclical fluctuations in business activity by Federal Reserve control of commercial credit? Explain.
6. Toward what specific objective should we direct our attempts to control credit? Discuss.
7. What powers does the Board of Governors of the Federal Reserve System now have, for regulating the total volume of commercial credit? Do you consider these powers adequate? Why or why not?
8. Give some idea of the number and extent of bank failures in 1929-33.
9. To what extent did these failures relate to non-member banks?
10. How do you account for the failure of member banks in the depression years of 1929-33?
11. Recent banking legislation is said to have provided for the divorce of commercial and investment banking. What is the meaning of this statement?
12. What change made by the Banking Act of 1935 enables member banks to secure more assistance than in the past from the Federal Reserve banks in time of trouble? Do you consider the change desirable? Explain.

13. Explain the federal plan to safeguard deposits in commercial banks under the Banking Act of 1935.
14. Discuss the problems which arise in connection with a plan of so-called "deposit insurance," such as we now have in the United States.
15. Is deposit insurance a necessary and desirable feature of a sound commercial banking system? Why or why not?
16. Why are further changes needed in the commercial banking system of the United States?
17. What is branch banking?
18. Would you expect branch banking to provide a solution for most of our urgent commercial banking problems? Explain.
19. "All commercial banks should be required to join the Federal Reserve System." Argue pro and con.
20. What is your attitude toward restricting commercial bank loans on real estate and securities?
21. "Legislation, even though strictly enforced, will not provide us with a sound system of commercial banking." What more is needed, and why?
22. What is the function of the investment bank?
23. Explain what is meant by the "selection," "underwriting," and "distribution" of securities.
24. Explain how the problem of providing safety for security purchasers became acute in recent years. How did the Federal Securities Act of 1933 undertake to provide this safety?
25. Criticize the Federal Securities Act both constructively and destructively.
26. Why was additional legislation necessary for the protection of security purchasers? How is the Securities Exchange Act of 1934 supposed to be helpful in this connection?
27. What problem exists in connection with the total volume of investment credit issued by investment bankers? In what respects are the investment bankers themselves responsible for the existence of this difficulty?
28. It is "obvious that our investment bankers exercise a large degree of control over production." In what way?
29. Is there any danger that investment bankers may come to dominate the industries of the country? Explain.
30. Can the problems of investment banking be solved while this business remains in private hands?
31. What advantages and disadvantages do you see in connection with the control of investment credit by a governmental board, as is sometimes proposed? Explain.

References for Further Reading

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7 PUBLIC EXPENDITURES

"GOVERNMENT," IT HAS BEEN SAID, "AS A FORM OF SOCIAL ORGANIZATION, HAS DEVELOPED BECAUSE, IN THE LONG RUN, IT HAS afforded the means of supplying men with certain services more efficiently and more economically than these could have been supplied by each for himself."[1] All economic systems of the present day are marked, to a greater or smaller extent, by division of labor. Each individual performs a single function, or a limited number of functions, and trusts to others to furnish him with the wide variety of commodities and services which he does not produce for himself. In the case of some services it seems the part of wisdom to look to the government for a more satisfactory performance than could be expected from private individuals or companies. The delegation of the provision of such services to and their performance by the government may be viewed simply as a part of division of labor.

The Nature of Governmental Functions.—These functions which are performed collectively rather than by individuals are of several kinds. Some services, such as furnishing protection or maintaining law and order, would be very difficult, if not impossible, for the citizen to perform for himself. Others that could be and sometimes are carried out by private companies are often turned over to the government in the hope that they will thus be performed more efficiently or cheaply. Examples are the provision of water and electricity by municipalities. Still other functions must be performed by the government, if they are to be done at all, because an individual's share in the resulting benefits is so small or so long deferred that he would not be moved by self-interest to undertake them himself. The establishment of institutions for dependents and defectives may be cited as an example. Even when an activity is left in the hands of private individuals, the government is often called upon to exercise a restrictive and

[1] H. L. Lutz, *Public Finance,* New York, D. Appleton-Century Company, Inc., 1936, p. 1.

regulatory influence. Thus we have a Pure Food and Drugs Act, a Sherman Anti-Trust Act, and other legislation designed to protect the interests of the public.

Governmental Functions and Expenditures.—The functions of governments—national, state, and local—though they differ in many particulars, are alike in one respect. They all involve the expenditure of funds. There has been a marked tendency for public expenditures to increase during the past few decades, not only in the United States but in other countries, and for both the national and other governmental units. By public expenditures we mean the disbursements by the various governmental units in the performance of the functions intrusted to them. Many students of the question feel that the increasing activities and expenditures of governments constitute a problem of vital importance to every individual. The problem in connection with public expenditures is to decide to what extent we may best satisfy our desires by the collective utilization of our resources, natural and human, rather than by leaving to private individuals the task of providing certain commodities and services. That is, we must consider how large a part of our real incomes we wish to receive collectively rather than individually. For the purpose of convenience in discussion, however, we shall deal with the problem in terms of money.

Increases in Public Expenditures

Expenditures of the Federal Government.—Let us consider, in the first place, the increase in public expenditures in the United States. The expenses of our national government increased from $517,000,000 in 1903 to $725,000,000 in 1913, $3,437,000,000 in 1928, and $7,766,000,000 in 1938.[2] The increase from 1903 to 1938 was 1403 per cent. However, even the enormous expenditures of 1938 were smaller than those of the last year of the World War, and of the early post-war years, as well as those of some of the recent depression years. In recent years, it has been the contention of the Roosevelt administration that only about one-half of the expenditures of the federal government have, in a given year, been regular in character, and therefore comparable to those of the other years cited. The claim is that the other expenditures

[2] *Report of the Secretary of the Treasury, 1928,* Washington, Government Printing Office, 1929, p. 418, and *New York Herald Tribune,* July 3, 1938.

have been for non-recurrent, emergency purposes, connected with the federal government's relief, recovery, and reform activities, made necessary by the great depression. If this explanation were accepted, the increase in the expenditures of the federal government from 1903 to 1938 would be cut approximately in half.

Of the emergency expenditures of the federal government in 1938, some of the most important were $1,472,000,000 for the Works Progress Administration, some $897,000,000 for the Public Works Administration, and about $500,000,000 for the Agricultural Adjustment Administration.[3] Other agencies of the federal government, such as the Commodity Credit Corporation, the Farm Credit Administration, and the Reconstruction Finance Corporation, which had spent large sums in earlier years, yielded the government a net income above new expenditures in 1937 and 1938.

Of the regular expenditures of the federal government, the largest single item is for protection, past, present, and future. The current expense for this purpose amounted to 39 per cent of total expenditures in 1928, or 80 per cent if the expenditures for debt redemption and interest are included.[4] The use of the larger figure might be justified on the ground that our national debt was large chiefly because the national government in certain past years furnished protective services at a more rapid rate than could be covered by the ordinary governmental receipts of those years.

In 1938, the expenditures of the War and Navy Departments were close to 25 per cent of the total regular federal expenditures for that year; and if debt redemption, interest on the public debt, and costs of the Veterans' Administration are included, the total cost of protection amounted to about 65 per cent of all regular expenditures. This larger figure is not strictly accurate, because the federal government borrowed heavily to finance its depression expenditures, and the interest on these depression debts, as well as on war debts, is included in the total interest paid in 1938. It is possible, also, that part of the debt redemption payments were applied to depression rather than war debts. But in any case it is clear that most of our regular federal expenditures go to pay the cost of past wars and to prepare for possible wars of the future.

Expenditures of the State Governments.—The state governments of the United States spent a total of $182,000,000 in

[3] *New York Herald Tribune,* July 3, 1938.

[4] *Cost of Government in the United States, 1927-1928,* New York, National Industrial Conference Board, Inc, 1930, p. 8.

1903, $379,000,000 in 1913, $1,889,000,000 in 1928, and an estimated $2,522,000,000 in 1936.[5] The increase in these expenditures from 1903 to 1936 was 1286 per cent. Large absolute increases took place in expenditures for education and social welfare. The largest relative increase was for building and maintaining highways. Detailed classifications of state expenditures are not available for the years since 1932, but in that year expenditures for building and maintaining highways amounted to about 45 per cent of the total expenditures of state governments; while those for education made up 24 per cent, and those for charities, hospitals, and correction, 11 per cent of the total.[6]

The Expenditures of Local Governments.—It is difficult to obtain accurate estimates of the total expenditures of local governments because of the great complexity of these governmental units. However, we may get an idea of the trend in local expenditures by examining those of a group of 146 cities for which the United States Bureau of the Census collected statistics in the past. These cities spent a total of $514,000,000 in 1903, $912,000,000 in 1913, and $2,952,000,000 in 1928. The increase in the period of twenty-six years was 474 per cent.[7] Statistics for these cities are no longer collected, but in 1936 all local governmental units spent an estimated $6,191,000,000, while cities of 100,000 population, or more, had expenditures of $2,624,000,000 in 1935.[8] The largest items of expenditure in these cities of 100,000 or more were, in 1935, for education; new capital outlays; interest; charities, hospitals, and correction; and protection to persons and property. These items amounted to 21, 14, 13, 13, and 12 per cent, respectively, of the total expenditures.

Reactions to Increases in Public Expenditures.—The great increases in public expenditures in this country have not escaped attention. The discussions of citizens, the speeches of politicians, and the editorials in our daily newspapers dilate upon the astounding costs of government, the incompetence of public officials, and the prevalence of extravagance, graft, and the misuse of public funds. The arguments advanced at hearings of tax commissions,

[5] *Statistical Abstract of the United States, 1935*, Washington, Government Printing Office, 1935, p. 205, and *Facing the Tax Problem*, New York, Twentieth Century Fund, Inc., 1937, p. 117.

[6] *Statistical Abstract of the United States, 1935*, p. 204.

[7] *Financial Statistics of Cities, 1928*, Washington, Government Printing Office, 1931, p. 31.

[8] *Statistical Abstract of the United States, 1937*, p. 224.

and the admonitions of men in high office, dwell upon the dangers of growing public expenditures.

In recent years, the protests against the increase in public expenditures have waxed increasingly bitter. We are told that government is the fastest growing of our many industries, and that all will soon be government employees, if the number of those working for the government continues to increase. We are warned that growing public expenditures make for an intolerable burden of taxation, that, indeed, the burden would even now be well-nigh intolerable if all our public bills were paid with funds derived from taxation—but they are not. Expenditures of federal, state, and local governments in 1936 came to about $137 per capita. This would seem to be a heavy burden on a national income which in that year amounted to less than $500 per capita.

The Growing Deficit.—All of our governmental units have found it impossible, in recent years, to secure sufficient revenue from taxation and other regular sources to meet their expenditures. Whenever the revenues of state and local governments do not cover their expenditures, it is necessary for them to borrow in order to carry on, since they cannot issue money in their own right. The public debts of our state and local governments more than doubled between 1922 and 1937. However, when public debts are mentioned, attention usually turns at once to the federal government. Its public debt reached $25,482,000,000 after the World War, but by 1930 it had been reduced to $16,185,000,000. Since 1930, the federal government has had a large deficit in every year, and its public debt is at present more than $37,000,000,000.

In Table 7, we give recent figures of federal expenditures, revenues, deficits, and the public debt. The federal government in 1938 was guaranteeing almost five billion dollars' worth of bonds issued by other agencies, in addition to its own direct obligations. Many people see, in federal finances of recent years, a very grave danger to the country. Of course, there is nothing particularly wrong in governmental borrowing to meet an emergency, when revenues fall short; but it is said by some that continuing deficits of several billion dollars a year are likely to lead to the destruction of the government's credit. If the public debt grows so large that full payment of interest and repayment of principal become improbable, the government will be unable to continue borrowing from its citizens. If it is then unable or unwilling to decrease expenditures or increase ordinary revenues, it may be forced to

TABLE 7.—EXPENDITURES, REVENUES, DEFICITS, AND PUBLIC DEBT OF THE FEDERAL GOVERNMENT, 1931–1939[a]

Year	Expenditures (Exclusive of Debt Retirement)	Revenues	Deficits	Public Debt
1931. . . .	$3,671,000,000	$3,190,000,000	$ 481,000,000	$16,801,000,000
1932. . . .	4,535,000,000	2,006,000,000	2,529,000,000	19,487,000,000
1933	3,864,000,000	2,080,000,000	1,784,000,000	22,539,000,000
1934. . . .	6,011,000,000	3,116,000,000	2,895,000,000	27,053,000,000
1935	7,010,000,000	3,800,000,000	3,210,000,000	28,701,000,000
1936	8,666,000,000	4,116,000,000	4,550,000,000	33,778,000,000
1937	8,442,000,000	5,294,000,000	3,418,000,000	36,425,000,000
1938. . . .	7,626,000,000	6,242,000,000	1,384,000,000	37,165,000,000
1939 (est.)	9,492,000,000	5,520,000,000	3,972,000,000	41,132,000,000

[a] Source: *Chicago Tribune*, January 6, 1939.

print paper money with which to pay its bills. Such inflationary tactics on the part of a government usually lead to an economic breakdown from which a country may not recover for a generation or more. It is held, moreover, that even if the situation does not lead to fiscal destruction, the government will pass on to coming generations a crushing burden of debt to be paid in the future.

There is at present a great hullabaloo about the need of reducing public expenditures and balancing the budget while there is yet time. But public expenditures are merely a surface indication of what is going on within a government. The proper point of attack, if an attack is needed, is not upon public expenditures themselves but on the activities of government which make the expenditures necessary. Before condemning either, however, we should analyze the causes of recent increases in public expenditures.

CAUSES OF INCREASES IN PUBLIC EXPENDITURES

Increase in Population.—Among the more obvious causes of larger public expenditures in this country is the steady increase in the number of persons for whom governmental services must be performed. This growth in population, even if it called for nothing more than a duplication of existing governmental machinery, would bring about at least a proportional expansion in expenditures, unless it were found possible to render governmental services on the basis of mass production, with a decreasing cost

per individual served. Unfortunately for our hopes in this direction, the performance of functions by the various governmental organizations seems to be subject to a law of increasing rather than decreasing costs; that is, it may be that an increase in the number of individuals cared for will involve a greater than proportional increase in the cost of rendering the services in question.

Not only does the performance of a given number of functions for an increasing number of persons bring with it an increase in the costs of government, both absolutely and per capita, but in addition it often happens that a growth in population causes an expansion of the needs which it appears necessary or wise to satisfy collectively rather than individually. A growth in the population of a city, for example, usually brings about an expansion in the number of functions to be performed by (say) the police department, and does not mean simply that the same functions will be performed as before, though for a larger number of persons.

Much light is shed on the tendency for governmental costs to be greatest per capita in thickly populated areas, by the statistics presented by the Bureau of the Census for certain cities in the United States for the year 1928.[9] It was discovered that per capita expenditures were greatest in the cities of 500,000 persons and over, where the average figure was $64.40 in 1928; while the lowest per capita expenditures, $40.22, were found in the group of cities having a population of from 30,000 to 50,000, which were the smallest cities studied. The decline in per capita expenditures is unbroken from the largest to the smallest cities. However, the variations in expenditures between different cities in each size group were also very large.

Changes in General Prices.—Changes in the general price level and the purchasing power of money constitute another cause of the growth of public expenditures. The general price level in the United States was slightly higher in 1913 than in 1903, and was much higher in 1928 than in either of these two other years. By 1932 prices were again low, but by 1935 they had risen somewhat. The national, state and local governments, in order to render the services expected of them, must be able to obtain materials and supplies, and in general to gain access to the factors of production much as does any business man. The governments, in other words, must enter into competition with private individuals and corporations for the use of the necessary agents of pro-

[9] *Financial Statistics of Cities, 1928,* p. 192.

duction. Hence, when the prices of goods and productive factors rise, the expenditures of governmental units must expand also, even though there is no change in the number of functions performed, or in the intensity with which they are carried on. Part of the increase in public expenditures since the turn of the century has been nominal, rather than real, representing, it is true, the handling of more dollars, but not the expenditure of greater purchasing power. This accounts, then, for a part of the growth of public expenditures as expressed in money.

In Table 8, the actual expenditures of federal, state, and certain local governments in certain years are combined with the expenditures of these governmental units when corrected for changes in the price level through the use of the wholesale price index number of the United States Bureau of Labor Statistics. We are assuming

TABLE 8.—EXPENDITURES OF FEDERAL AND STATE GOVERNMENTS AND OF CERTAIN LOCAL GOVERNMENTS, IN SELECTED YEARS[a]

Year	Amounts Actually Expended (000,000 omitted)	Amounts Expended When Expressed in Terms of "1926 Dollars" (000,000 omitted)	Per Capita Expenditures in Terms of "1926 Dollars"
		Federal Government	
1903	$ 517	$ 868	$10.72
1913	724	1,039	10.77
1928	3,347	3,519	29.37
1936	8,880	10,891	84.80
		State Governments	
1903	$ 182	$ 305	$ 3.77
1913	379	543	5.63
1928	1,889	1,935	16.15
1936	2,522	3,121	24.30
		146 City Governments	
1903	$ 514	$ 863	$10.66
1913	912	1,308	14.59
1928	2,952	3,023	25.23

[a] Sources noted in the text.

that these funds were spent for a sufficient variety of goods so that changes in this index number reflect with reasonable accuracy the changes that occurred in the purchasing power of the money spent by the government. While this correction for price level changes makes some change in the original figures, it still leaves a very considerable growth in public expenditures to account for.

Inefficiency in the Appropriation of Public Funds.—A third cause of the increase in public expenditures, or at least a reason for such expenditures being higher than they would otherwise be, is carelessness and extravagance in making appropriations for various purposes, combined with a lack of business methods, if not downright corruption, in the administration of government funds. The appropriation of funds with which to carry on the functions of the various governmental units in the United States is in the hands of elected representatives, that is, members of national and state legislatures and of city councils. Under our political system it often happens that the qualities which make it possible for a man to be elected to such an office are not those which will make him an expert in administering the duties devolving upon him. Public expenditures are determined, as a result, largely by men who lack training in economic principles and an understanding of economic problems. As a consequence, appropriations are often made in a haphazard and piecemeal fashion, some being entirely too small and more being disproportionately large, with each individual appropriation quite unrelated to any sum which might be regarded as an appropriate total.

Some improvement in this situation has taken place in recent years, since many of the governmental units, including the federal government itself, have adopted budget systems. A budget does afford some check upon appropriations, and it fixes to a certain extent the responsibility for them. However, it seems evident with each passing Congress that the evils mentioned above have not been completely eradicated. Indeed, it is likely that they cannot be eliminated until some change takes place in the attitude of large numbers of citizens toward the appropriation and expenditure of public funds.

The Popular Attitude Toward "Public Money."—The democratic form of government assumes that most voters will be intelligent and socially minded; that is, that they will know how best to serve their own interests and those of others, and that they will be sufficiently unselfish to take into consideration the

broad social interests rather than their own personal gain. One is tempted to doubt that this assumption is well founded, especially when one observes the attitude of some persons toward the funds of the federal government. Many people seem to regard the federal treasury as a vast reservoir into which flow mysterious but inexhaustible streams of wealth. It appears to such people that the problem in connection with the treasury is not one of economy in appropriations and expenditure, but rather that of seeing to it that their particular district or locality receives its full share of the funds—or more than its share, if possible. Representatives in the national legislature are conceived of by their constituents as agents of their district, whose duty it is to insist that an appropriate portion of governmental funds shall be diverted in its particular direction. Representatives are instructed to "bring home the money or don't come back."

The only way a representative is likely to be able to get through, for his district, an item in the appropriation bill is by enlisting the support of other members by promising to vote for the favorite projects of these members, or, in other words, by engaging in what is commonly called "logrolling" or "back-scratching." Examples of this practice are to be found in the river and harbor bills, the public buildings bills, the army and navy bills, and in most of our recent tariff bills. Scrambles for federal funds have been apparent in connection with the public works and relief programs of the Roosevelt administration. It may be noted, also, that those who complain loudly about federal extravagance and waste often grab vigorously at whatever federal funds are to be had. The probability of obtaining scientific and economical appropriations and expenditures in the face of such processes and attitudes is small.

Wastes in the Administration of Public Funds.—In the administration of governmental funds, as well as in the appropriation of such funds, undesirable practices may be noted. It is difficult to obtain proper administration of offices and funds, even given the best of efforts and intentions, when the holding of such offices is dependent upon the vagaries of political fortune. It is true that under our Civil Service Laws we have some slight modification of the old-fashioned "spoils system," under which appointments to government positions were generally regarded as a legitimate part of the fruits of victory at the polls; but there is still a high rate of "turnover" in offices which must be characterized

by security of tenure if efficiency is to prevail. Certainly, the folly of electing by popular vote officials who are to hold positions requiring technical knowledge and training should be apparent to everyone.

Though there are many public officials in the employ of the various governmental units who serve faithfully and well for modest salaries, it must be admitted that there are others who expend public funds in a wasteful and extravagant manner. This waste may take a variety of forms. In some cases the payrolls are padded—that is, more persons are employed than are needed to carry on the functions of government, and members of an administrator's family are often placed in appointive positions. Sometimes the quantities of supplies and equipment purchased are unnecessarily large, or the prices paid are unreasonably high in view of the quality obtained. Again, contracts may be awarded to those who have not submitted the most favorable bid for the work in question. We do not mean, of course, that only in governmental hands are funds wastefully expended, for much waste occurs also in private business expenditures.

The Expansion of Governmental Functions.—But after due allowance has been made for growth in population, changes in the price level, and waste in the appropriation and administration of public funds, there still remains a very large increase in public expenditures during the past thirty years to be accounted for. An explanation of this increase can be made largely in terms of the continually growing number of functions being performed by national, state, and local governments. The reasons given for this expansion of functions are many. Among them are the great economic and social changes which have occurred since the outset of the Industrial Revolution, the improvements in standards of living, and a growing spirit of humanitarianism. An analysis of some of these factors will require comparisons with conditions of many years ago.

The Growth of the Factory System.—When most branches of production were carried on in small units in workshops or in homes of the workers, the problems of industrial life were fairly simple. With the rise of the factory system, however, came long hours of labor in insanitary and even dangerous surroundings, the growth of cities, and the crowding of large numbers of human beings into squalid and unwholesome living quarters. As a result,

we have seen the passage and enforcement of laws regulating working conditions, hours of labor, and the labor of women and children, and providing for workmen's compensation in the event of accidents.

Unemployment and Monopoly.—Prior to the growth of industrialization and the rise of the factory system, the problem of unemployment was not a serious one. In recent years, however, the worker has become separated from the ownership of his tools and his product, and is dependent upon others for a chance to earn a living. The problem of unemployment is recurrent, and one that we have not yet learned to cope with satisfactorily, by either private or collective means.

Similarly, the problem of monopoly was not so important as long as production was carried on in small and scattered units. With the coming of the factory system and the growth of large-scale production with its many economies, monopolies and combinations have brought many pressing problems, and have required much legislation on the part of the national government, as well as the creation of the Federal Trade Commission as a sort of industrial referee.

The Division of Labor.—When a worker had to know his trade from start to finish and turned out completed units of product without the assistance of others, there was some chance that both he and his employer would know the value of his product and be able to agree upon a "fair wage." In these days of extensive division of labor the worker is often responsible only for the repetition of some minute portion of the manufacturing process. Under these conditions, neither the workers nor the employers can decide exactly how much the individual's part in production is worth, and many disputes result from this fact. Both sides organize to protect their own interests, and in the industrial warfare that accompanies conflict of interests there are strikes, lockouts, boycotts, sabotage, and sometimes acts of violence. Activity on the part of our various units of government has often arisen from labor disputes.

Railroad and Banking Problems.—As our facilities for the production of goods expanded, there was necessarily a development of the means of transportation. After a period of concentration on canals and highways came the growth of railway transportation, and with it a necessary expansion in governmental activities. For the regulation of the railroads has been a serious

problem for our federal government—one that is not yet satisfactorily solved. A similar development has taken place in our banking system. A period of wild disorganization was followed by the National Banking System, and finally by the Federal Reserve System with all of its complicated mechanism for providing adequate and safe credit facilities. Both federal and state governments are much concerned with the banking system at the present moment. The point that we wish to emphasize here is that our governmental activities in the fields of transportation and banking have led to an increase in public expenditure.

Development of Highways and Schools.—The largest items in the expenditures of state and local governments are for highways and education. The growth of these expenditures may also be attributed in large part to changes in the economic system and in standards of living in this country. In the days when the "horseless carriage" was considered on a par with feats of magic, highway construction and maintenance could be provided at a cost which would now seem remarkably low. However, the use of the automobile for pleasure has increased so rapidly that a car is at present regarded by most families as a necessity, while its use for commercial purposes has grown almost as rapidly. Traffic on the main highways has become extremely heavy, and the expense of constructing and maintaining macadam and concrete surfaces which will support giant motor trucks is very high.

As an economic system increases in complexity, it becomes more and more apparent that adequate preparation for one's life work is essential to the achievement of a high measure of success, and it becomes extremely difficult for a person to rise from the ranks if he depends upon his native ability unaided by occupational training. Also, as standards of living improve, greater educational facilities are demanded and obtained. For these and other reasons, we are at present attempting by collective action to provide everyone with a certain minimum amount of training, and to assist as many as possible to pursue higher education. Since little or no effort is made to place most of our educational activities on a self-supporting basis, the cost in the form of public expenditures is large.

Changing Attitude Toward Social Problems.—Although the provision of highways and educational opportunities may be considered social welfare activities in a broad sense, expenditures for social welfare are often taken to mean those for hospitals,

clinics, sanitation, and institutions for delinquents, dependents, and defectives, and the like. In the dreary days when the insane were left to "mumble in the chimney corner," when the feeble-minded were allowed to roam at will and were merely regarded as a bit queer, when such things as sickness or even plague were considered to be marks of the disfavor of the gods or of evil spirits rather than the results of lack of sanitation, and each family was expected to be able to furnish the means for providing for its own medical attention or to go without, governmental expenditures for social welfare purposes were not large. But nowadays we regard the satisfactory handling of such matters as vital to the public welfare, and undertake to provide for them through governmental agencies. Such provision is without doubt quite praiseworthy, but it should be remembered that it is also expensive.

Business Instability.—When production was carried on in small units by hand methods, and when to a great extent orders for the finished goods were placed in advance, business was relatively stable. We now have a system of mass production, with heavy overhead costs and production for a more or less indefinite future market, part of which takes the form of foreign trade. At times we have what we call business prosperity, with rising prices, heavy production, large extension of credit, and but little unemployment. At other times, we have periods of extreme dullness in business, marked by falling prices, a decline in production, contraction of credit, and widespread unemployment. Up to the present time, we have devised no adequate method of dealing with the problem of business instability as a whole, but our governmental units have been active in trying to assist those who are adversely affected by business depressions when they occur.

The Provision of Relief for the Unemployed.—Indeed, practically all of the increase in the expenditures of the federal government since 1929 has been caused by the government trying to cope with the problems of the post-1929 depression. One of the most important of these activities was caring for the unemployed. The number of unemployed was probably as great as 16,000,000 persons at the worst of the depression. Most of these people if unassisted would have been not only unemployed but completely destitute, lacking even those minimum resources necessary to keep soul and body together. With the state and local governments apparently unable to handle the problem, the federal government lent a helping hand. Its activities in behalf of the

unemployed, through the Public Works Administration, the Civil Works Administration, the Civilian Conservation Corps, the Works Progress Administration, and assistance given the states in providing direct relief, have been very costly. A preliminary report of the Senate Committee on Relief and Unemployment recently estimated that the federal government's expenditures for work relief and other types of public assistance amounted to $2,-891,000,000 in 1937, and had aggregated $14,200,000,000 from 1933 through 1937.[10] Moreover, it was recently estimated that the number of unemployed in the United States totaled more than 10,000,000 in April, 1938, despite the efforts of many agencies to deal with the problem.[11]

Assistance to Agriculture.—American agriculture was in a critical condition following the World War, and suffered still further losses during the depression. The agricultural problem and its treatment by the government will be examined in Chapters 19 and 20, but we may note here that the condition of agriculture during the depression was so serious as to constitute a severe drag on general recovery from the depression, in addition to being a difficult problem in itself. The federal government, through the Agricultural Adjustment Administration, the Farm Credit Administration, the Commodity Credit Corporation, and other agencies, attempted to regulate agricultural production, raise the prices of farm products, refinance farm mortgages, and lend the farmers credit on their holdings of various crops. The expenditures for these purposes have ranged from $500,000,000 to $1,000,000,000 a year; and the end is not yet, for the appropriation for the Department of Agriculture for use in 1939 is $1,090,000,000.[12]

Other Depression Activities.—Another project that involved billions was the Reconstruction Finance Corporation, which was designed to render financial assistance to railroads, banks, and other institutions. The federal government, at a cost of close to three billion dollars, attempted to refinance the obligations of home owners other than farmers, and contributed $150,000,000 to the Federal Deposit Insurance Corporation, which was organized to give security to bank depositors. Other depression activities of the federal government, which cost less than those already mentioned but formed important parts of the government's pro-

[10] *Chicago Tribune,* April 20, 1938.
[11] *Ibid.,* May 24, 1938.
[12] *New York Herald Tribune,* June 13, 1938.

gram, included the National Recovery Administration, which was intended to assist in the rehabilitation of industry and business through self-regulation; the regulation of the issue of new securities and of the activities of security exchanges through the Securities and Exchange Commission under laws of 1933 and 1934; the regulation of the public utility industry through the Securities and Exchange Commission and the Federal Power Commission under the Wheeler-Rayburn Law of 1935; the Tennessee Valley Authority; the Subsistence Homesteads Projects; the Emergency Housing Program; and the activities of the Federal Communications Commission, the Federal Alcohol Control Board, and the National Labor Relations Board. The administration of the Social Security Act through the Social Security Board promises eventually to be a very expensive project. The monetary and banking activities of the government resulting from the depression have thus far been conducted at a net profit.

Though the above list of activities recently adopted by the federal government is not complete, we have mentioned enough items to indicate the great increase that has taken place in the number of functions performed by the federal government and, incidentally, in the number of federal employees. It will be noted that we have not as yet attempted to evaluate or criticize the activities of the federal government, for we must first set up a criterion of the proper activities of government in general.

Proper Activities of Government

Our discussion has shown us that, except for allowances that must be made for such factors as changes in general prices, and extravagance and graft, the size of public expenditures depends upon the number and cost of the services which the various governmental units are called upon to render. Hence, in connection with the study of public expenditures, it is important to inquire how many functions should be assigned to the government. Since many of the functions now performed collectively could be carried on at least moderately well by other means, the answer which one person would give to this question might differ widely from that of another. There are some few individuals even today who believe that the ideal condition of society demands a complete absence of government. Others believe that government is a necessity but that its duties should be kept down to a minimum, while still others would have all industries owned and controlled by the

government—that is, by the people collectively rather than individually. Everyone would then work for the government; and it might be found wise, according to this opinion, to extend collectivism so far as to include the collective use of the products of economic processes.

A Test for Governmental Functions and Expenditures.—There is no necessary end or limit to the activities or functions of government. These activities might be reduced greatly from their present status, or they might be expanded until the government controlled all economic activity. It is merely a matter of what part of our real income we wish to acquire collectively, rather than individually. We greatly need a test which can be applied in deciding whether a given function involving a considerable expenditure should be assigned to a governmental unit or left in private hands.

We may get some notion of the nature of such a test by giving thought to the purpose for which governments exist. Functions are given over to governments to perform, with the idea that services will in this way be rendered more efficiently and cheaply than they could be provided by each individual for himself. Thus it may be said that a function should be delegated to the government only when it appears that, bearing in mind the necessary costs of administration in collecting and disbursing the funds together with whatever knowledge may be available as to the efficiency of the government in question, the expenditure of a given sum collectively will result in a more adequate and economical service than could be obtained by a similar sum privately spent.

A decision as to the aggregate amount to be collected and spent by governments in rendering the various services may be reached by having recourse to the familiar economic terms "satisfaction" and "productivity." Individuals spend their incomes for consumers' goods, usually after a consideration of the different amounts of satisfaction that are likely to be derived from the various alternative uses to which the funds in question might be put, or for producers' goods after a similar decision has been reached with regard to productivity. In other words, individuals tend to spend their incomes in such ways as will likely, all things considered, result in the realization of the greatest possible amount of satisfaction, or productivity, as the case may be. Applied to public expenditures, the principle as commonly stated is that

additional funds should be collected and spent by the government just so long as the amount of satisfaction to be derived in the aggregate from the new services rendered is in excess of the amount lost in the aggregate by having to give over the funds in question to the government.

This principle should be modified to allow for the fact that a direct comparison of satisfactions is not always the one to be made. Funds may be spent and hence have to be collected in such amounts and such ways as will indirectly have the rather serious effect of restraining or depressing business. For this reason the principle should be stated as follows: A government should collect and spend such an aggregate sum that the advantage in the form of satisfaction to be gained by any further collections and expenditures will not be sufficient to offset the disadvantage of loss of satisfaction, either direct, or indirect through the ill effects on business, by reason of turning the funds in question over to the government. Furthermore, just as an individual attempts to distribute his income among the various objects of expenditure in such a way as to make the last dollar spent for each purpose afford him as much satisfaction as could be derived from a like expenditure for any other object, so too it might be desirable to have the aggregate amount of expenditure of the government split up among the various governmental activities in such manner that no money will be spent for one purpose which would result in greater satisfaction if it were added to the sum to be spent for some other purpose.

Difficulties in the Use of This Test.—It must be admitted that this test for public expenditures has its disadvantages. It has often been said that satisfaction is a matter which each individual must decide for himself, and which as a consequence cannot be accurately measured by some individuals for others. And yet, in applying this test for governmental activities and expenditures, it will be necessary for us constantly to form an opinion as to whether the satisfaction to be gained from a service to be rendered by the government will or will not exceed the loss of satisfaction, direct or indirect, suffered by the various contributors supporting the government by turning over the necessary funds in the form of taxes. In addition, the application of the test will require an accuracy of estimate and a nicety of judgment which are not always possessed by those who make decisions on questions of governmental activities and expenditures. In spite of these objec-

tions, it seems that the considerations set forth in the preceding paragraph are those which should be borne in mind in reaching such decisions.

Inequalities of Wealth and Income and Governmental Expenditures.—Further conclusions of some importance may be reached by a consideration of the test for public expenditures. The sum total of public expenditures, according to this test, will tend to be greatest in countries where there are great inequalities of wealth and incomes. This is particularly true if a system of progressive taxation is employed to collect the funds, for under such conditions the satisfaction of added services of the government to the people who receive them, but who could not provide the services for themselves, will probably greatly exceed the satisfaction lost by those who are called upon to furnish the funds. On the other hand, whenever there is relative equality of wealth and incomes and whenever a system of proportional taxation is used, governmental activities may well be on a much smaller scale. It will also be true that in such a community the need for many governmental activities, especially those of the social welfare type, will not be so great as where wealth and incomes are very unequal.

The Need for Our Present Public Expenditures

On the basis of this test, does it appear that certain activities of our several governmental units should be curtailed or dropped entirely? We may first express doubt that any net social advantage would result from a decision not to have the governments carry on the various functions which they were performing in the regulation and guidance of economic activity prior to 1929. Nor does it appear that greater satisfaction would be created by leaving in private hands the funds now being collected and spent by the governments for various social purposes. The need for these services has come upon us gradually and inevitably with the changes that have taken place in our social structure, and it does not seem that the responsibility for performing these functions could have been avoided under any circumstances. Under present conditions it is unthinkable that such matters as education, highways, and the provision of institutions for the care of dependents, defectives, and delinquents should be neglected. On the whole, it must be said that the great bulk of these activities of governments may be expected to stand up under the scrutiny of the

proposed test for public expenditures. That is to say, these activities create sufficient satisfaction for the receivers of the services, or for society as a whole, to more than compensate for the loss of satisfaction to individuals or damage to business which may result because funds are collected in order to make it possible to carry on these functions.

The Need for Expenditures for Protection.—There is more doubt, however, as to whether a similar conclusion can be reached with regard to the principal ordinary activity of the national government—the provision of protection in one form or another. Expenditures for this purpose, as has been mentioned, make up a very large part of the total expenditures of our national government, and consist in the main of payment for past wars and preparation for those of the future. Without attempting to ascertain whether the wars of the past were necessary or the extent to which maladministration may have added to the costs of these conflicts, we may note that there is a growing conviction on the part of many persons that war is a foolish and extremely costly method of settling differences of opinion between nations. From the economic point of view, a war cannot be won by any of the contesting parties. Only economic loss is possible.

If the test of satisfaction is applied to this type of expenditure, there seems to be only one way in which the test may be stretched sufficiently to make it cover the activity. If the conditions of the world today are regarded as fixed, unyielding conditions to which we may react but which we cannot change, then perhaps preparation for warfare is necessary. If we must keep ourselves in constant readiness for conflict to escape being made the victim of aggressive warfare, it might be argued that the tremendous loss of satisfaction which we avoid by our heavy expenditures for protection is quite enough to make up for the large loss of satisfaction which is entailed because funds are diverted from other uses in order to provide protection. Even if such heavy expenditures are necessary for a particular country under present conditions, it must be realized that for the world as a whole the billions of dollars spent for wars of the past and for armaments of the present have been and are economic waste. There would be a greater sum total of satisfaction from the use of economic goods if the world were freed from military conflict.

The Need for Our Depression Expenditures.—What shall we say of the depression activities of the federal government? Al-

most any of them may be readily attacked from the individual point of view. That is, a person may condemn those activities which have raised or will raise his taxes and yet confer no direct benefits on him. From a social point of view, however, it is difficult to condemn many of these activities outright. The largest, and most severely criticized, depression expenditure has been for the maintenance of various governmental activities to provide work or relief for the unemployed and destitute. In so far as governmental assistance was received by those who really needed it, it is hard to believe that these expenditures did not give more satisfaction to the recipients of the government's aid than they took away, or will take away, from the taxpayers. However great the pangs suffered by those who have paid or must pay taxes to cover relief expenditures, they are doubtless less painful than the pangs of death by starvation or exposure.

Most criticisms of relief expenditures are probably partly justified. The administration may not have adopted the best methods of caring for the unemployed, and there has undoubtedly been some waste and graft in the administration of relief. It is probable that many workers on P.W.A. projects have some private employment as well, and that relief funds have been used in some cases toward political ends. The receipt of governmental assistance has undoubtedly weakened the morale of some persons and made them anxious to make a "career" of the W.P.A. or to retire on relief, rather than to shift for themselves in private employment. But after all is said and done, these facts seem to be well established: (1) Large expenditures for relief purposes were necessary in any case, during the depression; (2) most of the funds had to be furnished through the federal government; and (3) no administration of federal relief, however efficient, could have saved a sufficiently large part of the funds actually expended to have made any great difference in connection with balancing the budget.

Another expensive item in the depression activities of our government has been the assistance rendered to our farmers. Once again, the government may or may not have adopted the best methods for this purpose, and the gains that were realized may not have warranted the spending of so much money, but practically everyone felt in 1933 that business recovery was impossible so long as agriculture remained in a critical condition. To be sure, the agricultural problem might have solved itself in time, but few people wanted to wait for such an outcome. Even today both major

political parties agree that the farmer must continue to have aid, and their quarrel is confined to methods and costs.

What person, familiar with the facts, would suggest that expenditures for the conservation of soil and other resources are a waste of public funds? Who would say that we should now be better off if millions of farmers and home owners had been allowed to lose their farms and homes because the funds used to protect them were left in private hands? How can one condemn these types of public assistance, and at the same time approve the lending of billions of dollars to railroads, banks, and insurance companies through the Reconstruction Finance Corporation? Many other parts of the government's depression program are highly controversial in character, but, unlike those which we have mentioned above, they are not so likely to be attacked from the point of view of their money cost, so that their discussion has been or will be conducted in other chapters.

Balancing the Budget.—If some of the most costly depression functions of our federal government were necessary and unavoidable, it seems clear that the budget could not have been balanced during the past few years, regardless of which major party was in power. It is inconceivable that any party could have carried on the same depression functions at a sufficient saving to have kept the budget in balance. The dangers of an unbalanced budget are often exaggerated through likening the government to a private individual. If an individual persistently spends more money than he takes in, it is clear that he will come to financial grief—and this is true likewise of a government in the long run. But the problem of the individual is to adjust his expenditures to his income, while that of the government is the reverse. That is, the government habitually decides upon the functions it should perform, and then undertakes to collect enough revenue to carry on these functions.

While it is true that, in the long run, persistently large deficits would tend to destroy the government's credit and lead to an orgy of inflation, this does not mean that a national budget must be balanced every year, or in every period of a few years. If a national emergency requires expenditures in excess of collectible revenues, a government would be foolish not to permit its budget to become unbalanced. When a man needs a surgical operation, he does not hesitate to call in the surgeon merely because the cost would unbalance his budget for that year. Perhaps the sanest attitude

toward the budget question is to suggest that the budget of the government should balance *over an entire business cycle.* In depression periods, the governmental expenditures always increase while revenues fall off sharply in spite of all that can be done. Hence, in good business years it should collect more revenue than is necessary to carry on its current functions so that a reserve may be built up against the next depression.

The National Debt.—Since the budget of our federal government has been unbalanced for several years, we may well ask how dangerous is the present position of federal finances. Since the beginning of the depression, the national debt has grown from 16 to 37 billion dollars, and is now at its highest level in history. However, while our national debt has grown to about $286 per capita, that of Great Britain was more than $700 per capita as long ago as the end of 1935, while France's national debt is estimated at about $525 per capita.[13] Moreover, in view of our vastly greater wealth and resources, it is probable that we could support a much larger per capita debt burden than either of these two other countries. Our national debt is now only a little over 10 per cent of the pre-depression value of the wealth of the United States, and the interest payments on this debt absorbed only between one and two per cent of our national income in 1937. The government's bonds continue to find a ready market, and at very modest interest rates. All in all, people are probably not justified in contending, as some people do, that federal finances stand on the edge of an abyss, and that almost any day may witness the government's acknowledgment of bankruptcy.

The Burden on Future Generations.—Another complaint about our public debt is to the effect that we are arranging to pass on to our children and grandchildren a staggering burden of debt which they will have to pay, to their own great detriment. Though this argument has very little of actual economic significance, it is nevertheless rather popular and demands some attention. Clearly, in the sense of *real income,* future generations can hardly suffer from a large public debt incurred now. When the government borrows to buy wheat to feed its starving citizens, the wheat is taken not from the crops of thirty or fifty years hence, but from present supplies. When cotton is plowed under with borrowed funds, it reduces the current crops, not those which our grand-

[13] *New York Herald Tribune,* July 3, 1938, and *New York Times,* December 13, 1935.

children will reap. What really happens when the government borrows is that our citizens are induced to turn over to it a part of their current money income. With these funds, the government is able to secure a larger share of our *present national real income* than it could otherwise obtain, and private individuals must get along with a smaller share than they would otherwise have. In the sense of real income, then, the cost of public borrowing is borne now in the form of a smaller real income for private purposes than would otherwise be available. Of course, when taxes are finally collected to pay off the debt, they may be so large in amount or collected in such ways as to hamper and restrain business and impair the effectiveness of our productive facilities, thus reducing real income in future years, but there is nothing about public borrowing which, in and of itself, leads to such a result.

But even if the size of the national real income in the future is not likely to be affected by present increases in the public debt, may it not at least be said that a *financial* burden is passed on to future generations? It is true, of course, that taxes must some day be collected if the government is to pay interest and principal on its obligations, but at the same time these amounts will be paid to the owners of the government bonds which represent our public debt. If the people who own the bonds also pay the taxes, even private individuals may "break even" on the process. But whether certain *individuals* gain, lose, or break even, it is clear that the *nation as a whole*, in paying off the public debt, merely transfers money from one pocket to another. This transfer is not necessarily without significance, for the economic effects of the reinvestment of funds by bondholders may not be the same as would have followed the spending of identical sums by the taxpayers. Of course, bondholders may spend their funds (instead of investing) when the bonds are paid off, and taxpayers, on the other hand, might have invested the funds (instead of spending), if they had not had them taken away in the form of taxes. We come to the conclusion, then, that there is no guaranty as to what the effects of future transfers of money income may be. Ordinarily, the transfer should not be very harmful.

However, the dangers involved in increasing the national debt become greater the longer the process continues, and the federal government has had substantial deficits for eight consecutive years. The federal program for 1939 includes $3,700,000,000 worth of "pump-priming" through public works and relief, and a

Department of Agriculture appropriation of more than a billion dollars. A naval expansion program, to cost in the neighborhood of $1,100,000,000, has been authorized. The deficit for 1939 is now estimated at approximately four billions, and the public debt is expected to reach 41 billions in that year.

Many people have applied the term "spendthrift" to the 1938 session of Congress, because it made appropriations totaling some $12,000,000,000. But this is not necessarily a sound attitude. We might, with perfect propriety, decide to receive $18,000,000,000 or $24,000,000,000 of our income through the government each year. However, once we have reached a decision as to the number of functions we want the government to perform, we should undertake, at the earliest possible moment, to pay the bill out of current income. Deficits and additions to the public debt are excusable in depression years, but, if continued indefinitely, they can lead only to disaster. However, the principal dangers of borrowing for public purposes are those which may affect us at present, and not a generation or more hence.

The Control of Public Expenditures

The Need for a Changed Public Attitude.—One objection that may well be raised against public borrowing for depression purposes is that, since taxes are not collected at once to cover the full governmental expenditures, it seems a very simple and easy matter to get a greatly increased volume of governmental services. This fact is likely to delay a much-needed change in the public attitude toward public funds and expenditures. Regardless of the number of functions we feel the government should perform, we must keep in mind continually the direct relationship between the functions of government and the cost of government. Our extravagance in handling public funds in the past may be traced in large part to the desire of individuals to get a full share of the seemingly inexhaustible store of wealth in the public treasury. Inefficiency and corruption in government flourish when the public attitude is one of indifference if not of condonation. It is necessary that the people be made to understand that there is no such thing as "government money" apart from the contributions of those individuals who support the government by the payment of taxes, fees, and the like. Every expenditure of public funds means inevitably a definite burden in the form of taxes either at that time or later.

When a person is heard to complain about the high taxes exacted by the national government, he should be asked his attitude toward international cooperation and disarmament. As we have seen, by far the greater part of the ordinary expenditures of the national government are for purposes of protection, which means that they represent primarily the cost of maintaining military and naval forces. Those who take pride in our military and naval showing should certainly be eager to bear their full share of the cost of our army and navy. It is scarcely reasonable or patriotic for one to demand that government funds be spent in his district for the erection of a court house or a post office or for the widening of a creek, unless he expects to contribute in tax payments to a fund that will enable other districts to have similar glorious but often quite unnecessary developments.

Indeed, as we have already pointed out, our legislators are able to obtain such appropriations for their districts only by cooperating with one another in a give-and-take fashion. Well-paved streets, magnificent highways, and ornate school buildings do not spring full-fledged from the ground. They can be constructed and maintained only at great expense, and this expense sooner or later must be borne by the taxpayers. Similarly, if the sight of human beings in want and misery causes a citizen's heart to bleed, so that he wishes them to be provided for by governmental action, he must remember that these functions of government will in the long run cause a drain upon his own purse. Surely a saner attitude toward public finance on the part of the people of the country will follow an understanding of the relation between taxation and public expenditures, and go far toward bringing about efficiency in the appropriation and administration of the public funds. However, once we have recognized fully that governmental activities are not free, but involve a definite cost, it is our privilege to decide calmly and deliberately what services we wish the government, instead of private enterprisers, to perform for us. And since we will pay the bill, we are entitled to make the number of such services great or small, as we see fit.

Efficiency in Government.—The nature and extent of the functions which the government is to perform having been decided, it is the part of wisdom for a people to insure that public expenditures shall not exceed those amounts which, with reasonable standards of efficiency, may be required to carry on these activities. Carelessness, inefficiency, and corruption should not be

tolerated. To eliminate such evils, many writers on public finance recommend a reform of the budgetary mechanism to obtain a closer adjustment of appropriations to needs and to fix responsibility, changes in the Civil Service Laws to bring a more efficient system of governmental employment, provision of security of tenure and more adequate salaries in order to attract higher types of employees into the government service, and, in general, the introduction of sound business methods into the operation of governmental affairs.

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1. Why is it desirable to have certain services provided by governments rather than by private agencies?
2. In what way is the problem of public expenditures related to the performance of these functions by governments?
3. What has been the trend in recent years in the volume of expenditures made by the federal government in the United States? Explain the nature of the principal items of expenditure.
4. What has been the trend in recent years in the volume of expenditures made by state and local governments in the United States? Why?
5. What danger is involved in operating a government at a deficit? Explain.
6. What relationship exists between the growth of population and the growth of public expenditures? Explain.
7. "A part of the increase in public expenditures in the United States in the twentieth century has been nominal, rather than real." What is the significance of this statement?
8. How does inefficiency in the appropriation and administration of public funds affect the total of public expenditures?
9. What is meant by "the popular attitude toward public money"?
10. How have economic and social changes been responsible for a part of the increase in governmental functions and expenditures?
11. What has been the influence of the growing spirit of humanitarianism upon governmental functions and expenditures? Why?
12. How did the great depression following 1929 affect governmental functions and expenditures? Explain.
13. "The problem in connection with public expenditures is to decide how large a part of our real incomes we wish to receive collectively rather than individually." What is the significance of this statement in setting up a criterion for public expenditures? Explain.
14. It is said that a certain large eastern city pays the sum of $100,000 yearly for the storage of its voting machines during

periods when they are not in use. Comment upon this governmental expenditure in the light of the test for public expenditures proposed in this chapter.

15. In the light of the proposed test for public expenditures, how would you criticize the major items of expenditure of the various governmental units in this country in the past?
16. If, as some writers suggest, it is no less incorrect economically to speak of "winning a war" than to talk about "winning an earthquake," why is it that we spend so large a part of our national income for submarines, battleships, and bombing planes?
17. Comment on the necessity for the principal depression expenditures of our national government in recent years, in the light of the suggested test for public expenditures.
18. Could the budget of the national government have been kept in balance in recent years? Explain.
19. Is it necessary that the national budget shall balance every year? Explain.
20. Have recent increases in the national debt endangered the credit of our federal government? Why?
21. Does public borrowing shift the *financial* burden of public expenditures to future generations? Explain.
22. Does it shift the *real* burden to future generations? Explain.
23. Why is there need for a changed public attitude toward public expenditures?
24. How should we seek efficiency in the conduct of government?

References for Further Reading

See list of references at the end of Chapter 8.

8 TAXATION

ONCE A DECISION HAS BEEN REACHED AS TO THE FUNCTIONS TO BE PERFORMED BY GOVERNMENTAL AGENCIES, THERE REMAINS the task of determining the method or methods of procuring the funds from which the proposed public expenditures may be made. At times the national governments have deemed it wise to manufacture their own purchasing power. In other words, they have printed large issues of inconvertible or "fiat" money which they have used in paying for the governmental functions. The effect of this additional purchasing power, competing with the money already in circulation for the existing supplies of commodities and services, has been to deprive the individual citizens of a part of their purchasing power just as effectively as if the governments had exacted tribute from these citizens in the first place.

As we noted in the preceding chapter, governments have commonly borrowed to obtain funds for public expenditures. This method has been used whenever it has appeared undesirable or impossible to obtain sufficient funds for current expenditures from current sources of revenue. Our federal government, up to the beginning of the depression of 1929, had done most of its borrowing in time of war. By borrowing, we get government services in the present and pay for them on the installment plan over a long period of years. Occasionally certain units of government secure small amounts of revenue from the conduct of various public service enterprises, but this is not ordinarily an important source of public income.

The Nature of Taxation.—The most important source of the funds from which public expenditures are made has been and will doubtless continue to be taxation. A tax is "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."[1] In connection with this definition

[1] E. R. A. Seligman, *Essays in Taxation,* New York, The Macmillan Company, 9th ed, 1921, p. 432.

several observations should be made. First, a tax is a compulsory contribution in that the amount to be paid is decided by the government, as are also the time and method of payment, without regard for the wishes of the individual taxpayer. In the second place, there is in taxation no definite *quid pro quo*; that is, the taxpayers are required to contribute to the support of the government on some basis other than the amount of benefit or service directly received by them from the government. It often happens that the persons called upon to pay the largest taxes are those who are least dependent on governmental services and who could best provide for themselves if the services in question were not performed by the government. Finally, the purpose of a tax is to provide revenue for carrying on various functions in the interest of the public. In this connection a serious question often arises as to whether a tax may properly be made the instrument for the accomplishment of some ulterior purpose, such as the reduction of existing inequalities of wealth and income.

The Problem of Taxation.—Since all governmental units of the present day find it imperative to obtain the greater portion of their revenues from taxation, the problem of taxation becomes one of securing these necessary revenues in such manner as will, among other things, involve the smallest possible expense in collection and administration, interfere as little as possible with the conduct of business and economic progress, and distribute the burden of supporting the government in as equitable a manner as possible.

Tests of a Sound Tax System

Fiscal Adequacy.—Since the purpose of taxation is to provide large amounts of revenue for the different units of government, the first and most important test of a tax system is whether it will furnish sufficient revenue. The satisfaction of this test alone does not insure a perfect system of taxation, for many other important considerations must be borne in mind; but the inability to meet this test is of itself quite enough to make a tax system a failure. It matters little how convenient, economical, or simple the system is, or how well it succeeds in distributing the tax burden according to the high principles of equity and justice, if it does not provide the necessary revenue for the performance of the functions of government. Indeed, in times of great emergency—such, for example, as when a war is being waged—other factors are

disregarded and the sole consideration of the government in passing upon tax rates and methods becomes that of fiscal adequacy.

Economy.—As has been said, a tax system is set up in order to obtain a certain amount of revenue which is necessary for the performance of governmental functions. A sum must be collected from the taxpayers, however, which is larger than the amount to be spent by the government in question, in order to cover the costs of collecting and administering the taxes. Other things being equal, taxes which involve the collection of large increments of revenue, with a minimum of complaints and bookkeeping details to be handled, are preferable to those which necessitate the collection of a multitude of small sums and involve great complexity of administrative machinery. In the words of Adam Smith, "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."

However, in connection with the test of economy, as well as with that of fiscal adequacy, the effects of taxation on the taxpayer and upon business in general must be considered. No tax is fiscally adequate, however great the revenue which it produces, and no tax is economical, however small its cost of collection and administration, if it is levied in such fashion or to such extent as to discourage business activity, curb individual initiative, or check unduly the accumulation of capital. It would be possible to devise a very simple system of taxation, the burden of which would rest entirely upon large incomes and large accumulations of wealth; but while this system might be a marvel of adequacy and economy for a time, its long-run results might easily be disastrous because of its effects on capital accumulation and business initiative. Almost everyone admits the validity of this principle, but there are great differences of opinion as to the exact point at which these undesirable effects would show themselves if higher and yet higher taxes were assessed on large incomes and great stores of wealth. It is probable that this point has never, as yet, been reached in actual practice in this country.

Simplicity, Certainty, and Convenience.—Simplicity is another desirable feature of a tax system. The provisions of our tax laws should not be complicated, but should be so worded that they may readily be understood by those who must pay the taxes as well as those who administer the tax laws. It is scarcely likely that any system of taxation could be set up which would be understood

in all its ramifications by all of the taxpayers and officials concerned, but it is certain that our present laws leave room for a large measure of progress in the direction of simplification.

A sound tax system will also be characterized by certainty. It is probable that our economic system could in the long run become adjusted to either a high or low level of taxation with something like equal success, but uncertainty seems ever to be productive of undesirable results. Witness, for example, the effect of uncertainty as to the provisions of an impending tariff bill upon business activity in the United States! Uncertainty in taxation also provides many opportunities for chicanery and corruption in the assessment and collection of taxes.

Taxes should be collected at such times and in such a manner as will be most convenient for the taxpayers. It is not possible, of course, to have all taxes marked by convenience of payment, but we retain some taxes, such as those on commodities, which are very convenient to pay though they fall far short of perfection with regard to some of our other tests. In general, convenience of payment is a desirable quality whenever it can be obtained.

Elasticity.—Writers on the subject of money and banking are in general agreement that one of the principal defects of our money and credit system prior to 1913 was its inelasticity. The quantity of money and credit could not be enlarged sufficiently to meet the emergency needs of business, and recurrent periods of monetary stringency and even financial panics resulted. Inelasticity is a serious defect in a system of taxation, also, for it means that the revenue received from the taxes in operation cannot be expanded to meet the larger needs which may be experienced from time to time. Consequently, if the tax system lacks elasticity, there are likely to be frequent deficits and a dependence on borrowing to secure the funds with which to meet current obligations.

Equity.—A final requisite for a sound tax system is that it shall be equitable. Once it is ascertained that a given system of taxation is likely to provide an adequate amount of revenue, the next most important consideration is to have the tax burden distributed among the taxpayers in an equitable manner. This consideration becomes increasingly significant as the size of the aggregate volume of taxation increases. Years ago, when public expenditures were relatively slight and the total burden of taxation was not heavy, almost any system was likely to be reasonably fair. This would not be true at the present time. In view of the importance

of the principle of equity, it will be well to inquire further into its meaning as applied to a system of taxation.

The Benefit Theory of Taxation.—Many persons have held in the past that a tax should not be defined as we have defined it, but should be considered a payment to the government because of, and in proportion to, benefits received from it. Thus a person who benefited greatly at the hands of the government would be expected to pay a large sum in taxes, while one who derived but slight satisfaction from services rendered by it would not be asked to give any considerable portion of his income to its support. However, though the benefit principle seems very just in theory, it has been largely abandoned because of the apparent impossibility of applying it in practice. In the first place, it is not possible to determine exactly how much benefit each citizen receives from the government. Here we are dealing with the matter of individual satisfactions, which cannot be accurately appraised except by each for himself. In the second place, even if benefits could be correctly estimated, we might find that the persons receiving the largest benefits from the services rendered by the different governmental units were the very ones who were least able to spare any great amount in taxes to pay the costs of such services. On the other hand, as we have already said, those with very large means might well be able to provide for themselves many services now rendered by the various governmental units. Thus they would be less dependent than the poor upon these services, and could not be called upon to make any large contributions to the government on the basis of the benefit principle.

The Principle of Ability to Pay.—Most economists and writers on public finance at the present time have gone over to the principle of ability to pay, which holds that each individual should be taxed, for the most part, according to his ability to make contributions to the support of the state, without regard to the amount of benefit he may derive from the activities of the government. This principle seems on the surface to be admirably simple, but its interpretation is extremely difficult. What, for example, shall be the test of ability to pay? The answer to this question used to be that the possession of property was a clear indication of ability to pay taxes, and it was decided that any man who was fortunate enough to own great quantities of wealth should be required to contribute large amounts to the governmental treasuries. As time went on, economists came to suspect that some modification of

this answer was necessary, for many individuals were receiving large incomes annually but were escaping the tax-gatherer altogether under the prevailing system of general property taxes.

Income as an Indicator of Ability to Pay Taxes.—It may be said that today the greatest emphasis is placed upon income as a test of ability to pay, although property is by no means completely disregarded in this connection. This does not mean, however, that it is necessary merely to discover the amount of a person's income in order to pass judgment on his ability to pay taxes. Many other matters must be borne in mind, such as whether the income in question is "earned" or is derived from investments, whether it contains any elements such as the return on diminishing assets, whether it represents any surplus over and above the returns necessary to induce the individual to continue to perform his services or lend his capital, and, finally, the length of time over which the income is received.

Proportion vs. Progression.—Probably the most important question in connection with the principle of ability to pay relates to the way this ability increases as income increases. In other words, as a man's net taxable income increases, does his ability to pay taxes increase exactly in proportion to this increase, or more or less slowly? If A has a net taxable income of $10,000, while that of B is $5000, is A able to pay exactly twice as much in taxes as B, more than twice as much, or less than twice as much, supposing the considerations mentioned in the preceding paragraph to be the same for both individuals? These are questions that can be answered only after a further examination of the meaning of the principle of ability to pay. If we decide that A's ability to pay is exactly twice as great as B's, then taxation should be proportional—that is, the same rate should apply to both individuals—and at this rate A's contribution will be double that of B. If A has less than twice the ability of B to pay taxes, the rates of taxation should be regressive, that is, a lower rate should apply to the larger incomes than to the smaller. Finally, if A's ability to pay taxes is more than double that of B, the rates of taxation should be progressive, that is, the greater the income the higher the rate of taxation which is applicable to it.

Diminishing Satisfaction and Income.—The advocates of progressive taxation base their arguments in large measure on the theory that the satisfaction to be derived from the expenditure of a unit of money income diminishes as the total income of the

spender increases. A certain amount of income is necessary as a minimum for subsistence, and does not represent ability to pay in the true sense of the term. The first increments of income above this minimum amount are used by the individual to satisfy urgent wants, while further and yet further additions to income will be used to satisfy less and still less important wants. It follows that, unless we are dealing with individuals who choose to satisfy their less pressing desires before attending to those which are more urgent, diminishing satisfaction is experienced in the expenditure of successive increments of income. Thus, it is held that the man with an income of a million dollars a year is not losing nearly so much satisfaction when compelled to give up one hundred thousand dollars in taxes as is the man with ten thousand a year when he contributes a thousand dollars to the support of the government, although it is clear that the rate is the same in these two instances. It may seem equitable, then, for the recipients of large net taxable incomes to pay taxes at higher rates than those applied to men receiving smaller incomes, which means, of course, the use of progressive rates of taxation. Most students of public finance are content with progressive rates of taxation wherever they may at present be satisfactorily applied—which means for all practical purposes in the taxation of incomes and inheritances. It should be apparent that a progressive tax upon a commodity, say tobacco, which would mean a high rate if the purchaser were rich and a low rate if he were poor, would not be practicable.

Distributing the Burden of Taxation.—In the light of what is known about diminishing satisfaction in the spending of income, just how should the tax burden be distributed in order to follow the principle of ability to pay? Some writers suggest that the principle of equal sacrifice should be followed. That is to say, the distribution of the tax burden according to the principle of ability to pay is held to be perfectly realized when all taxpayers contribute such amounts that an equal loss of satisfaction, or an equal amount of sacrifice, is experienced by each. Other writers hold that the proper principle to follow is that of least aggregate sacrifice. According to this principle, no person should be required to pay any tax whatsoever so long as the same amount could be obtained from another person with a smaller loss of satisfaction—that is, at a smaller sacrifice on the part of that person. The adoption of this principle would mean that any aggregate amount of revenue

would be secured with a minimum aggregate sacrifice or loss of satisfaction.

A third theory holds that the principle of ability to pay would be best served if the tax burden were distributed in accordance with the "net utility of income" to different persons.[2] By net utility of income is meant the margin between the total satisfaction obtained through spending one's money income and the total cost or sacrifice necessary to obtain this income. All of these theories dealing with the proper distribution of the tax burden would be difficult to apply in practice because they deal with such subjective matters as satisfaction and sacrifice, which are influenced by all the vagaries of temperament, tastes, and sensitiveness of individuals, and are extremely hard to estimate for large numbers of persons. However, all the theories here mentioned point to the use of *progressive* rather than *proportional* rates of taxation, whenever the former can be applied. The rates of taxation would be mildly progressive under the theory of equal sacrifice, more steeply progressive under the theory of net utility of income, and very steeply progressive under the theory of least aggregate sacrifice.

The Opposition to Progressive Taxation.—The foes of progressive taxation advance several arguments which they believe show its undesirability. In the first place, it is suggested that the diminishing satisfaction theory of income spending cannot be proved; that the accumulation of great means brings with it a host of new wants that clamor for satisfaction; that no test can be applied to numerous individuals to determine accurately the benefits derived from spending income or the sacrifice of giving up a portion of it; and that, so far as we can judge on the basis of behavior, a tax of a given rate hurts a man of great income just as much as it does a man of small income. It may be true that the theory of diminishing utility as applied to income is not susceptible of proof, but it is nevertheless logical to assume that successive installments of income over and above the minimum for subsistence will be applied to the satisfaction of progressively less urgent wants. There can be little doubt that, as old wants are more and more completely satisfied, new wants arise on which further income may easily be spent; but these new wants are much more likely merely to retard the rate of decline in the satisfaction

[2] Advocated in H. W. Peck, *Taxation and Welfare*, New York, The Macmillan Company, 1925, pp. 243-262.

derived from spending money income than to maintain this satisfaction unimpaired from increment to increment.

A second charge against progressive rates of taxation claims that the result of their application is to penalize most severely those individuals who are most productive in our economic system, thus checking individual initiative and enterprise. This argument does not apply to all large incomes that are hit by progressive rates, because many of the largest incomes are dependent chiefly upon the return received from investments made in the past and not upon payments for services rendered in the present. The question here is not whether individuals will continue to save and invest, but whether they will continue to seek to earn large incomes when these are taxable at progressive rates, with surtaxes in addition. It seems most reasonable to conclude that individual initiative will not be greatly impaired by progressive taxation, at least as applied in this country. Moreover, no individual has only his own ability to thank for the large income which he may receive for his services. Society itself plays a part in building up these large incomes, and progressive taxation coupled with the surtax aims merely to recover for society a portion of the surplus accruing to these men of large incomes, over and above that amount which is remuneration for services rendered. Individual initiative and enterprise will not be seriously checked so long as a portion of this surplus remains in the possession of these persons. It must be remembered, also, that the amount of total net income left to the individual after the payment of the tax increases with every increase in the total taxable income that he receives.

A more serious argument, if a sound one, is to the effect that progressive taxation and the surtax check the accumulation of capital. It is said that we are chiefly dependent upon large incomes for the surplus from which comes our supply of capital. Progressive taxation tends to reduce the inequality of incomes and hence the supply of savings. Since economic progress is thought to be contingent upon the steady accumulation of capital, these large incomes are believed by some to be justified, even though many of them are unearned. It seems very doubtful, however, that progressive taxation interferes seriously with the accumulation of capital. It would be difficult to devise a system of accumulation which would be more wasteful than the present. Indeed, some economists today are of the opinion that waste comes about by reason of actual overaccumulation of capital and a failure to

maintain the proper balance between saving and spending for consumers' goods. Again, it is true that capital formation often takes place when expenditures are made by governmental units quite as much as though the funds were left in private hands. Finally, we may add that by far the greater part of saving is done automatically and without sacrifice. Especially is this true of the savings of persons of great wealth and income, and those of large corporations. Most interest payments involve a considerable element of saver's surplus, or income in excess of that necessary to bring about saving. As a result, it seems unlikely that the progressive taxation of incomes interferes to any great extent with saving and the accumulation of capital.

Our general conclusion must remain, then, that a progressive system of taxation should be resorted to, if we wish the burden of taxation to be distributed according to the principle of ability to pay.

The Incidence of Taxation.—In deciding whether a particular tax system is equitable, it is of vital importance to know who ultimately bears the burden of the various taxes levied. It has long been customary to divide taxes into two classes, direct and indirect. *Direct taxes* are those which are collected at the outset from the persons upon whom it is intended that the burden shall fall, such as a tax on the rent of land. *Indirect taxes* are those collected from one group of individuals with the expectation that the burden will be shifted by them to a different group. The classification of taxes into direct and indirect groups has proved to be unfortunate. In some cases, we find so-called direct taxes being passed on, in part at least, to others than those from whom the tax was originally collected, while at other times so-called indirect taxes have not been shifted, but have remained a burden upon those who paid them in the first place. Wholly apart from any classification, however, the problem of the "incidence," or ultimate burden, of taxation is extremely important.

The study of the shifting and incidence of taxation is a branch of the study of value. To know whether a tax on a given commodity is likely to be shifted, it is necessary to ascertain whether the conditions of production and sale for that commodity make it possible for its price to be raised so as to pass the amount of the tax on to the consumers. If the tax in question is one which is levied on some factor of production, such as land or capital, it is necessary to make a similar investigation into the conditions

which determine the price of this factor of production, in order to discover whether the tax can or cannot be shifted.

THE FEDERAL REVENUE SYSTEM

As may be seen from Table 9, the federal government derived 96.4 per cent of its total revenue in 1938 from taxation. Of the total federal revenue, the personal income tax yielded 20.6 per cent; corporation taxes, 23.7 per cent; payroll taxes, 11.9 per cent; estate and gift taxes, 6.7 per cent; excise taxes, 27.7 per cent; and custom duties, 5.8 per cent. The revenue from non-tax sources was 3.6 per cent of the total. We shall now turn to an examination of these several types of taxes.

The Personal Income Tax.—The taxation of personal incomes was a productive source of revenue in 1938, although this tax has in some other years yielded an even larger share of the total federal revenue. In applying the tax, after the deduction from gross income of the necessary expenses of acquiring it, an exemption of \$1000 is allowed a single person, and one of \$2500 for a married couple or head of a family, together with \$400 for each dependent. A credit of 10 per cent of the amount of one's *earned* income is also allowed. Taxable income (that is, income above the exemptions noted) is taxed at the flat rate of 4 per cent. Additional taxes, called surtaxes, which make the personal income tax progressive, begin at 4 per cent on net taxable incomes of \$4000 to \$6000, and reach a maximum of 75 per cent upon portions of net taxable income which exceed \$5,000,000 a year.

Merits of the Personal Income Tax.—The income tax is quite generally considered to be a good tax. It falls directly on income, from which all taxes must come eventually, if sometimes indirectly; and income is the most widely accepted indicator of ability to pay. The tax has usually yielded a very large revenue but, being based on realized income, the receipts obtainable are likely to decline at times when the government needs especially large revenues. The income tax lends itself readily to progressive rates, which we have found to be essential to any logical interpretation of the principle of ability to pay. It is certain as to time and manner of payment, but is only moderately successful from the point of view of economy in collection. It must be remembered in this connection that not all the tests of a sound tax system need be satisfied by any one tax. A tax may be defective in a number of respects and yet have its deficiencies well compensated by other

TABLE 9.—SOURCES OF FEDERAL REVENUE AND PERCENTAGE DISTRIBUTION, FISCAL YEARS 1937 AND 1938

Source of Revenue	1937 Amount Received (in millions)	1937 Per Cent of Total Revenue	1938 Amount Received (in millions)	1938 Per Cent of Total Revenue
Personal income tax	$1,094	20 7	$1,286	20 6
Corporation income tax	1,055	19 9	1,300	20 8
Capital stock tax	137	2.6	139	2 2
Excess profits tax	25	0 5	37	0 6
Unjust enrichment tax	6	0.1	6	0 1
Payroll taxes (social security and railroad retirement)	266	5.0	743	11 9
Estate tax	282	5.3	382	6 1
Gift tax	24	0.5	35	0 6
Excise taxes:				
Liquor taxes	594	11 2	568	9 1
Tobacco taxes	552	10.4	568	9 1
Other stamp taxes[a]	70	1.3	46	0 7
Manufacturers' excise taxes[b]	451	8 5	417	6.7
Miscellaneous taxes[c]	98	1.9	132	2.1
Customs duties	486	9.2	359	5.8
Other revenues[d]	154	2 9	224	3 6
Total revenue[e]	$5,294	100 0	$6,242	100 0

[a] Such as taxes on playing cards and capital stock transfers.
[b] Included, in 1937, taxes on lubricating oils, matches, gasoline, electricity, toilet goods, fur goods, trucks, automobiles, motorcycles, tires and tubes, radio sets, phonograph records, electric refrigerators, sporting goods, firearms and supplies, cameras and lenses, chewing gum, candy, and soft drinks.
[c] Included taxes on the use of telephone, telegraph, radio, and cable services; the transportation of oil pipe lines, theater admissions; safe deposit boxes; oleomargarine, narcotics; club dues and initiation fees; and other taxes.
[d] Included interest, exchange, and dividends; fines and penalties; fees, forfeitures; assessments; reimbursements, gifts and contributions, sale of governmental properties, sale of services; rents and royalties; permits, privileges, and licenses; mint receipts; forest reserve fund; postal receipts from the Canal Zone; deposits in postal savings funds in the Canal Zone; and the federal share of District of Columbia revenues.
[e] Sources. *New York Times*, September 27, 1937, and October 6, 1938.

taxes, so that the system as a whole conforms to the requirements set up.

Defects of the Tax.—The personal income tax law is complicated, and a person of income often needs legal advice in arriving at the amount of tax he must pay. The method of assessment is by the taxpayer's declaration of his income, supplemented by information as to amounts paid in salary, interest, or other types of income, furnished by employers and others who make the payments. This method of assessment requires a high degree of ad-

ministrative efficiency if the tax is not to be merely one on honesty and to lead to widespread evasion. The tax discriminates, in effect, between different persons since, among other things, the law exempts from income tax the wages and salaries of state and municipal employees and income on certain tax-exempt securities issued by various governmental units.

A defect in past income tax laws was a provision permitting taxpayers to offset current income with capital losses—such, for example, as losses sustained by selling securities at prices lower than those paid for them. In recent years, the regulations relating to capital gains and losses have been much improved. The extent to which such gains and losses are permitted to figure in income tax computation at the present time is 100 per cent in the case of assets held less than eighteen months, 66⅔ per cent for assets held from eighteen months to two years, and 50 per cent for those held for still longer periods. Capital losses may be used to offset only capital gains, and not current income, although losses may be carried over for one year in order to offset gains.

The surtaxes on personal incomes run so high under the present laws that persons who have very large incomes are tempted to seek ways and means to avoid paying income taxes; and the legal fraternity has been quite successful in devising such methods for their wealthy clients. The federal government attempts through legislative measures to close these loopholes, but the lawyers usually manage to keep a step or two ahead of the law.

It is difficult to define income for purposes of taxation, and our laws do little more in this respect than to enumerate various taxable and non-taxable items. Under the law, as now interpreted, some peculiar situations arise. For example, a farmer need not count as taxable income the food and shelter provided by his farm, but no similar privilege is accorded those who must buy their food and shelter with money income. Similarly, a house owner who occupies his house need not count as taxable income the shelter he enjoys, but if he rents the house to another the rental that he receives is taxable. Clearly, there is room for improvement in the application of the income tax to different people. Improvements frequently suggested are: (1) To increase the number of income taxpayers by lowering the present exemptions by about one-half, and at the same time doing away with many of the present excise taxes and customs duties; (2) to treat all capital gains and losses as current income, and tax the gains as they occur rather than

when realized through the sale of assets; and (3) to work for the mutual taxation of securities and employees' incomes between the federal government and other governmental units.

The Incidence of the Income Tax.—In discussing the incidence of the income tax many writers try to view the tax as a whole, and come to the conclusion that a tax on incomes cannot be shifted. It is argued that there is nothing about an income tax that enables individuals or companies to raise the prices of the goods they are selling, or makes the personal services or the capital furnished by individuals command a higher return. Consequently, it is said, all efforts to pass income taxes on to others are doomed to failure. A sounder approach to the problem, however, is to break up the income tax into its component parts before proceeding with the analysis.

The Income Tax and Labor Incomes.—A part of the tax on personal incomes may be said in the first instance to fall on the return for labor or services rendered. It is generally admitted that a tax on the labor income from a single occupation will tend to be shifted. If, for example, a considerable tax were to be placed on the labor income of plumbers, but not on that of other workers, the wages in this occupation would tend to rise until they were about as high, after allowing for the tax, as before. The burden of the tax would tend to be distributed over all labor, because the only way in which the wages of plumbers can rise (assuming no increase in the demand for their services) is to reduce the number of plumbers. This means more persons available for other occupations, and consequently slightly lower wages all around than before. Whether the shifting works out well depends to a large extent upon the movement of labor out of the plumbing trade and into other occupations, and it is probable that the process would in any event require a considerable period of time.

The federal income tax, in so far as it is a tax on labor income, in one sense is, and in another is not, similar to the tax just discussed. To be sure, the tax is not applied to any particular occupations, and yet as a matter of fact it falls on very few. The income tax is by no means as democratic as many suppose. Between two and three million persons in the United States pay income taxes in most years. Not only is this a small percentage of our income receivers, but the tax affects the labor incomes of the more highly paid occupations only. If the tax is to be shifted, it will be because the number of people in these occupations declines, which increases

the marginal productivity of those remaining and brings a higher remuneration. It is not possible to say definitely whether or not this will happen. If it does, it will come about only in the long run, and will be caused by fewer persons preparing for and entering these occupations, rather than by an exodus of those already engaged in them.

The Income Tax and Interest on Capital.—The income tax is, to a certain extent, a levy upon the return paid for the use of capital. If a tax applied only to the income from capital invested in certain industries, there would be a tendency for capital, in so far as it is mobile, to leave these industries and flow to others not subject to the tax. In this way, the amount of capital in the industries that are taxed would decrease, and its rate of remuneration would rise until, with the tax deducted, the rate of interest was as high as the rate in other industries. The federal income tax, in so far as it falls upon the income from capital, does not discriminate but applies to all lines of industry. Hence, the shifting cannot come about in the manner just described. If a shift does occur, it will be because the tax on the income from all capital is sufficiently burdensome to discourage saving and check accumulation. In this event, the supply of capital decreases, its marginal productivity rises as compared with that of labor and land, and its remuneration increases until the rate of interest is so high that the burden of the tax is not borne by the owners of capital. However, it is not at all certain the tax will have this effect on saving and accumulation, for reasons given above.[3]

The Income Tax and the Rent of Land.—In part, economic rent may be the income which is taxed by the federal income taxation. To the extent that this is true, the tax will tend not to be shifted. The amount of rent paid for the use of land is fixed by the conditions of demand for and supply of land. There is nothing about a tax on rent that makes people willing to pay a greater sum for the use of the land, nor can such a tax have the effect of reducing the amount of land available. Since neither demand nor supply will be affected, it is clear that the rent of land cannot be increased for the purpose of passing on the tax burden to others. Some people find it clearer to regard rent as a surplus which capital and labor produce in combination with some land, over and above what these factors could produce if they were applied to marginal lands. A tax on rent could not have the effect of

[3] See pp 229, 230.

increasing this surplus, however, and consequently could not be shifted.

The Corporation Income Tax.—The corporation income tax produced 20.8 per cent of the total federal in 1938. As applied at present, the tax is rather complicated. Corporations having net earnings of less than $25,000 in a year pay 12½ per cent on the first $5000, 14 per cent on the next $15,000, and 16 per cent on the next $5000. A flat tax of 16½ per cent is levied on the net earnings of banks, insurance companies, and mutual investment companies. Other corporations that have net earnings of $25,000 or more pay a tax of 16½ per cent on their net earnings, provided all the earnings are distributed to the stockholders. If a part of the earnings is retained by the corporation, a surtax is applied which increases as the proportion of retained earnings increases, so that the total tax may be as high as 19 instead of 16½ per cent. This surtax is all that remains of the once famous tax on additions to corporate surpluses.

The original taxes on additions to corporate surpluses, which were much heavier than those which apply at present, were provided in the Revenue Act of 1936. Prior to that year, corporate net income, after the payment of the corporate income tax, could be reinvested in the business without being taxed further; but if distributed to stockholders it was formerly subject to personal surtaxes, and is now subject (after payment of the corporate income tax) to both normal income taxes and surtaxes. Through the device of reinvestment, values were turned over to stockholders, in the form of enhanced prices and earning power of their shares, and the taxes which would have been imposed if cash dividends had been declared were evaded.

The tax rates in 1936 were 7 per cent on the first 10 per cent of undistributed corporate income, 12 per cent on the next 10 per cent, 17 per cent on the next 20 per cent, 22 per cent on the next 20 per cent, and 27 per cent on all net income retained over and above 60 per cent of the total. However, those corporations which earned $50,000 or less had to pay no more than 7 per cent on the first $5000 of undistributed income, no matter how large a percentage of the total income this sum might be. The taxes on additions to corporate surpluses were intended to equalize tax conditions as between private persons and corporations. Corporate income, if paid out to stockholders, was subject to both corporation and personal income taxation, while if retained by the cor-

poration it was subject to the corporation income tax and the tax on additions to corporate surpluses. The new taxes were expected to prevent individuals from evading their personal income surtaxes through the accumulation of corporate surpluses. Some people hoped that, through this public control over corporate earnings, overinvestment and misdirection of savings might also be prevented.

The taxes on additions to corporate surpluses were never popular. They were combined with so many other corporation taxes that corporations were in reality taxed more severely than private persons, and equality between stockholder and private person was not achieved. It was also objected that, under this law, small corporations would have difficulty in building up necessary surpluses and providing for expansion. Some thought that all corporations would be injured by not having adequate reserves for use in time of depression, and that they would be forced to lay off their workers more promptly than otherwise at such times. Whatever the merits of these opposing arguments may have been, the tax is now largely a thing of the past. It seems very doubtful, however, that its virtual repeal will have the stimulating effect on business which was predicted by critics of the tax.

The corporate income tax has been a good income producer although, like the personal income tax, its yield diminishes greatly in poor business years. This tax is not open to many of the objections urged against the personal income tax, though in the case of both it is difficult to decide what constitutes net income. However, the corporate income tax is open to certain objections, noteworthy among which is the suggestion that it does not conform to the principle of ability to pay. Some people contend that a corporation has no ability to pay taxes apart from the ability of its stockholders to pay. If this is true, the size of a corporation's net income bears no necessary relationship to its stockholders' ability to pay taxes. For one corporation with a moderate net income may distribute it in large amounts to its few stockholders, while another with a huge net income may hand this income in small amounts to its hundreds of thousands of stockholders. This objection raises an interesting question: Is ability to pay a subjective or psychological attribute which attaches only to flesh-and-blood persons, or is it an objective characteristic which may be possessed, also, by an artificial person such as a corporation?

It is sometimes argued that this tax is objectionable because

it results in double taxation, not only as between corporation and stockholder, but also as between corporation and corporation. Let us suppose, for example, that a corporation makes a certain net income, pays the tax on it, and declares a dividend. A part of the dividend may go to another corporation which owns a part of the stock of the first. This dividend payment becomes a part of the income of the second corporation and is subject to tax. In the case of a complicated holding company structure, this sort of thing might occur several times. However, this objection loses much of its force when we realize that under the present law 85 per cent of intercorporate dividends are exempted from taxation.

As between corporation and stockholder, the corporation pays the tax on its net income and then pays dividends to the stockholder. The dividends are personal income to the stockholder, and, under the present law, are subject to both the normal personal income tax and the surtax, if the dividend income is sufficiently large. This is unquestionably double taxation, but if the corporation retains the net income and adds it to surplus, it is at present subject to a second tax anyhow. It seems to us that double taxation is bad only if it is unintentional, or if the total amount collected is unreasonably high. If double taxation is intentional, and the two taxes together impose only a fair burden upon the income affected, there seems to be little or no cause for complaint.

Incidence of the Corporation Income Tax.—It is doubtful whether this tax burden can be passed on to consumers of the products of these businesses in the form of higher prices, or whether any considerable portion of it can be transferred to the laboring group. If the tax should be passed on to the stockholders in the form of smaller dividends, a loss of capital and the eventual failure of some firms near the margin might result; and this situation, in turn, might make possible an advance in prices for the other firms and thus enable them to pass on some of the tax burden to customers. It seems likely that this will not happen, however, and that the tax will not be shifted. It is our intention in the present discussion to hold fast to what may be called the general principles of tax incidence, leaving the many qualifications and changes in assumptions which might in some cases alter the conclusions to those "who love to turn economics into a playground for logical exercises."

The Capital Stock and Excess Profits Taxes.—The combination of capital stock and excess profits taxes produced only

2.8 per cent of federal revenue in 1938. The rate of the capital stock tax is now $1 per $1000 of the declared value of the corporation's capital stock. A corporation may earn 10 per cent on the total declared value of its capital stock without paying any excess profits tax. However, it must pay an excess profits tax of 6 per cent on net earnings between 10 and 15 per cent, and of 12 per cent on net income in excess of 15 per cent, on the total declared value of its capital stock.

The capital stock tax may be expected to yield a fairly stable annual revenue regardless of corporate earnings, but it may be burdensome in times of depression. The capitalization of corporations is, of course, a rather defective index of their ability to pay taxes, for a corporation with large capitalization may have small earnings, and vice versa. However, the tax is small and is not progressive. The excess profits tax will not yield a stable annual income, but it accords fairly well with the principle of ability to pay. A tax which appropriated all profits would be a bad tax, because it would prevent a corporation from offsetting, with the profits of certain years, the losses suffered in others. However, after a reasonable rate of return has been allowed, as an offset to possible losses, further earnings may properly be regarded as surplus income and be subjected to taxation.

The chief problem in the taxation of excess profits in the past has been to arrive at the valuation of a corporation's assets. Such a valuation must be determined if the tax is to apply to earnings in excess of a certain percentage of the value of the corporation's properties; but the valuation of businesses by the government has proved to be slow, costly, and troublesome. The present combination of capital stock and excess profits taxes is therefore ingenious. Under the law, a corporation may place any valuation it pleases on its capital stock. However, if it declares capital stock at a low figure, though it will pay a small capital stock tax, it will be required to pay a large excess profits tax if the business is successful and has net earnings which constitute a high percentage on its low declared value. On the other hand, if it declares an unusually high value for its stock to escape the excess profits tax, it must pay a high capital stock tax, regardless of whether its earnings are high or low. Corporations have been given a second opportunity to declare the total value of their capital stock, and are to be given a third, but thereafter the declared value will stand, for better or for worse. When business becomes really

prosperous once more, this combination of taxes is likely to produce a somewhat increased annual revenue.

Punitive Corporation Taxes.—We should note, in addition to the taxes already described, certain punitive taxes on corporations. In the past, the wealthy have often organized personal holding companies to receive and hold their incomes, in order to evade personal income surtaxes. There is now a tax on the undistributed net income of such companies, which takes 65 per cent of the amount of undistributed income under $2000 and 75 per cent of the amount over $2000. There is also a penalty surtax on corporations which improperly accumulate surpluses so that their owners may avoid personal income surtaxes. This tax is 25 per cent on the first $100,000 improperly added to surplus, and 35 per cent on all additional amounts. Revenue derived from these taxes is reported under the corporation income tax. Finally, there was in 1938 the "unjust enrichment" tax. This tax of 80 per cent was levied on corporations which had received, by order of the Supreme Court, A.A.A. processing taxes previously paid to the government, and which had already reimbursed themselves for these taxes by shifting them to others.

Proposed Change in Corporate Taxation.—Such is the veritable maze of taxes applied by the federal government to corporations. In addition, the corporations are subject to various state and local taxes. The federal government, as we have seen, taxes corporations not only to secure revenue from their income, but also to prevent the use of the corporate device as a means of evading personal income taxes and surtaxes. Much could be done to improve certain of these corporation taxes, but perhaps the greatest improvement would be to abandon the taxation of corporations and corporate incomes as such, at the same time bringing corporate incomes under the personal income tax. It would seem that this could be done by requiring every individual to declare annually, as part of his personal income, his proportionate share in the earnings of any corporations in which he was a stockholder, regardless of whether these earnings were actually distributed to the stockholders. Corporate net earnings would thus be included in individual incomes, for purposes of income taxation, and opportunities to use the corporation as a device for evading personal income taxes and surtaxes would be eliminated. In this way, also, we should avoid the complexities and inequities of the present system of corporate taxes, and eliminate the troublesome

question as to whether a corporation has ability to pay taxes, apart from the ability of its stockholders.

Payroll Taxes.—In 1938, payroll taxes produced 11.9 per cent of the revenue of the federal government. These taxes are collected for the accumulation of reserves required under the Social Security and Railroad Retirement Acts. The taxes levied under the Social Security Act have been described in Chapters 3 and 4. Considering payroll taxes from the point of view of public finance, we suggest that those which fall on the employees operate as a crude sort of income tax, for all employees who come under the Act pay the same percentage of their wages. The taxes paid in the first instance by the employers will tend to be shifted to either the workers or the consumers, and will be regressive in operation. It would probably be better, from the point of view of equity, to support the various old age and unemployment projects out of general revenues, but the tax-consciousness promoted by payroll taxes may be desirable.

The Estate and Gift Taxes.—The combination of the estate and gift taxes produced 6.7 per cent of the total federal revenue in 1938. The estate tax is applied to estates as a whole rather than to shares received by individual heirs. The first $40,000 of an estate is exempt. The tax varies from 2 per cent on the first $10,000 above the exemption to 70 per cent on that part of an estate which is in excess of $50,000,000. Credit is given against the federal estate tax for 80 per cent of any amount which is paid in taxes under state inheritance tax laws. The gift tax, which is necessary to prevent the evasion of the estate tax through transfers of wealth between living individuals, has rates which are three-fourths as great as the estate tax rates. That is, they vary from 1½ per cent to 52½ per cent on amounts from $10,000 to $50,000,000 above the exemption, which is now $4000 in any one year.

The estate tax has never produced a very large revenue, but it is likely to be more productive in the future since we now have an adequate gift tax to help make the estate tax effective. The estate tax can be relied upon to produce a fair amount of revenue, but it is not a good source of increased revenue if the increase must be made available suddenly. The tax unquestionably accords with the principle of ability to pay. Inherited wealth is purely a surplus return to the heir, and is entirely unearned by him. The greater the amount that society permits to be passed on through

inheritance, the greater is the share which society may legitimately claim from an estate. The incidence of the tax is clear. Its burden rests wholly upon the receivers of the estate and cannot be shifted. The tax is certain as to amount, and as to time and manner of payment.

Objections to Inheritance Taxes.—There are, however, at least two possible objections to the estate tax which the government should be careful to meet. In the first place, it is argued that, if the tax is too high, it will lessen the efficiency of business men and slow down the process of saving and capital formation. It is said that one of the strongest motives for working to acquire a large income, and for saving and accumulating a fortune, is the desire to provide adequately for one's dependents. If the inheritance tax is very high, some men might not seek to acquire large incomes, or might spend them for current enjoyment, and as a consequence the vital process of saving and capital formation would languish.

There is undoubtedly some truth in this contention. The desire to provide adequately for dependents is one reason why men work, save, and accumulate. However, there are many other motives operating in the same direction, such as the desire for luxurious living, the wish to provide for one's old age, and a yearning for prestige and power; so that capital formation probably would not cease even if inheritance were entirely eliminated. In any case, the present federal taxation of estates is not likely to have any detrimental effects upon our economic system, for $40,000 may be passed on free of tax and estates of even $100,000 or $200,000 are not greatly reduced by the tax. Indeed, some authorities on taxation urge that the estate tax rates should be increased and the exemptions lowered, with particularly high taxes applied to properties which were inherited twice or oftener. It is urged, also, that gift tax rates in the lower brackets should be raised, so that they will no longer provide so great an incentive as at present as a means of evading the higher rates of the estate tax.

Another objection to an estate tax is its inconvenience in payment. Many estates are left largely in the form of real estate, factories, machinery, and securities, and not in cash. Unless the heirs have other large sources of income, they may have to liquidate the inherited properties to pay the tax and, at a forced sale, might have to sell at a considerable loss. In this way, an heir might lose 40 or 50 per cent of the value of an estate on which the

estate tax was only 25 per cent. This objection is taken care of to some extent, by granting a reasonable period of time within which to pay the tax, and by providing for the revaluation of an estate if its value has declined between the date of death of the decedent and the date on which the tax must be paid.

Excise Taxes.—In 1938, excise taxes of various kinds produced 27.7 per cent of the total revenue of the federal government. Excise taxes are taxes on economic goods. In some cases, producers are compelled to buy and affix tax stamps to the articles they sell. Again, the producers may be required merely to pay the government a certain amount per unit of product produced and sold. Some of the taxes are specific, as for example a tax of (say) 5 cents per package of 20 cigarettes; while others are *ad valorem* taxes, as for example the tax of 10 per cent on the price of automobiles.

While taxes such as these are usually collected from the manufacturer or producer in the first instance, their burden is borne in the end by the ultimate consumer. The general explanation is that the imposition of a tax of this kind upon the manufacturers of a certain product, say playing cards, constitutes one of their expenses in the production of that article. Unless the commodity will sell for a price sufficient in the long run to cover *all* costs of production, including the federal tax, some readjustment of the volume of production in the industry will result. If our theory of long-run value is to allow for differential costs among producers, we may say that some producers at and near the margin will be forced to withdraw from production. If the theory of long-run value, on the other hand, eliminates differential costs by supposing that the industry is completely organized into representative firms, the industry will be compelled to adjust itself to a smaller volume of production. In either case, the result is the same for our present inquiry. A smaller volume of output will ensue which, under given conditions of demand, will enable producers to charge a higher price. Thus, a part or all of the tax will be shifted to the consumers.

The Incidence of Excise Taxes Under Competition and Various Cost Conditions.—Whether the burden of all or only a part of the tax, or of more than the amount of the tax, will be passed on to consumers in the form of higher prices depends in large measure upon conditions of cost in the industry in question. If the industry is one of increasing costs, it will be possible to adjust it to a smaller volume of production, in the long run, at a

somewhat lower cost of production per unit than the cost prior to the imposition of the tax. Hence, in order to cover all costs of production, including the tax, it will not be necessary, other things being equal, to raise the price by the full amount of the tax, but rather by something less than that amount.

If the industry is one of decreasing costs, it will be possible for the industry, in the long run, to become adjusted to a smaller volume of production only at a somewhat higher cost per unit than that which existed before the tax was applied. Under these circumstances it may be seen that, other things being equal, it will be necessary for the price of the product to rise by an amount greater than the tax if all costs of production, including the amount of the tax, are to be covered by the selling price.

In an industry which operates under conditions of constant costs, there is strong reason to believe that the price of the goods taxed will rise by an amount just sufficient to pass the burden of the tax on to the consumers. Such an industry can adapt itself to a smaller volume of production, in the long run, at exactly the same cost per unit as prevailed before the tax was imposed. It will be remembered that the curve which is usually drawn to represent constant costs shows that the industry can adapt itself to widely different volumes of output at the same cost per unit of product, but it does not show that any amount of the good will be produced at less than this price per unit, so the tax will have to be shifted in its entirety. On the other hand, an indefinite amount of the product would be produced at a price slightly higher than this constant cost per unit, so it is not likely that an amount greater than the tax will be added to the selling price. It follows, then, that the volume of production will be adjusted in such a way that the price will be raised just enough to cover the constant cost per unit, plus the tax.

Excise Taxes Under Monopoly.—We have thus far been considering the incidence of taxes on goods produced under conditions of competition. Taxes on goods produced by monopolies may produce quite different results. Under monopoly conditions there is no tendency, in any period of time, for the price of a product to equal costs of production. The object of the monopolist is to set such a price for his product as will, all things considered, bring him the greatest possible total net revenue above cost of production. In doing this, it is necessary for him to consider the elasticity of demand. If the demand for a product is very elastic,

so that an increase in its price will mean a great fall in the number of units that buyers take, the monopolist may find that he still makes his greatest possible total net profit by producing and selling the same number of units at the same price as before the imposition of the tax. In this case, he must bear the tax himself. On the other hand, if the demand is inelastic, he may find it possible to shift the entire tax to consumers. Indeed, the selling price may, under certain conditions, rise by more than the amount of the tax.

The Merits and Demerits of Excise Taxes.—In general, the burden of taxes on commodities and other economic goods, no matter where it is first placed, tends finally to fall as a whole or in large part upon the consumers. Because of this fact, these taxes, judged by themselves, do great violence to our principle of ability to pay. They are not progressive, nor are they even proportional to income. People of large incomes pay these taxes in greater absolute amounts than people of small incomes, but the percentage of total income spent for economic goods subject to excise taxes tends to decline as a person's total income increases. Therefore, these taxes take away a smaller *percentage* of a large than of a small income, and are regressive in operation. This does not mean that they should never be imposed, for their bad effects may be quite offset by other taxes in the system. Excise taxes have been good revenue producers in the past, and have been considered a rather elastic element in the tax system. Their convenience in collection and payment is well known, for they "get the feathers with a minimum of squawking." They are often included in the prices of articles in such a way that most consumers are unaware that they are paying them.

Customs Duties.—Customs duties, or duties on imports, produced only 5.8 per cent of the total federal revenue in 1938. These taxes have lost importance rapidly, for at one time they produced almost all the revenue of the federal government. The revenue from import duties is largely incidental at the present time. The United States is the world's leading exponent of the protective tariff. The primary purpose of our tariff act is to protect American industries by excluding foreign products from our markets. To the extent that the tariff is successful in this purpose, the consumers of this country are certainly burdened, and ordinarily to a greater degree than the protected manufacturers are benefited; but tariffs that actually exclude goods do not interest us in connection with our study of taxation, since they bring no revenue to the govern-

ment. The rates applied to some imports, however, do not exclude the foreign products, and imports continue to come in despite the duties. In these instances, revenue results for the government. The import duties paid on commodities from abroad, regardless of how they are collected, ordinarily will have the same incidence as taxes on the production of domestic commodities; that is, they will fall on the final consumers. Hence, these taxes may be criticized in much the same terms as those applied to excise taxes above, except that the fiscal adequacy of customs duties may be more seriously open to question than that of excise taxes, since the primary object of our tariff is protection.

The Federal Tax System as a Whole.—In some respects, it is difficult to summarize our study of the federal tax system. Some of its taxes are direct, others are indirect. Some are convenient and economical to collect, others are not. Certain generalizations may be made, however. The federal tax system as a whole ordinarily meets fairly well the test of fiscal adequacy. In depression years, of course, it sometimes fails to provide enough revenue to cover all expenditures which must be made, but it is difficult to imagine a tax system which would be depression-proof. Unfortunately, about half of the revenue of the federal government is now obtained through indirect taxes, whose burden tends to be shifted to the final consumer, or through other regressive taxes. Hence, about one-half of the federal revenue comes from taxes which do not conform to the principle of ability to pay. As was previously suggested, it might be well to broaden the base of the personal income tax, in order to increase the revenue from this source. At the very least, it would be desirable to do away with the excise taxes, with the possible exception of those on liquors and tobacco, before lightening the burden of the income tax. Customs duties should also be abolished, with the exception of tariffs for revenue or special duties designed to prevent the dumping of foreign products in this country. The question of customs duties will be considered more fully in Chapter 11.

State Revenues

The states are less dependent than the federal government upon taxation for their income, for they frequently derive as little as three-fourths of their total revenue from taxation. Their other sources of revenue include special assessments; fines, forfeits,

and escheats; subventions, donations, and assessments; interest, rents, and highway privileges; earnings of general departments; and earnings of public service enterprises. In Table 10, we present the sources of state tax revenue in 1936.

State Income Taxation.—Because of the great variations in tax laws from state to state and the limitations of space, it will not be possible to discuss in detail the tax provisions of the several states. It is necessary to limit the present discussion to such general

TABLE 10.—SOURCES OF STATE TAX REVENUE AND PERCENTAGE DISTRIBUTION, FISCAL YEAR 1936[a]

Source of Revenue	Amount Received (in millions)	Per Cent of Total Tax Revenue
Personal income taxes	$ 107	5.2
Corporation income taxes	88	4.3
Other corporation taxes	206	10.1
General property taxes	158	7.7
Sales taxes	276	13.5
Inheritance taxes	114	5.6
Motor vehicle taxes and licenses	254	12.4
Motor fuel taxes	519	25.3
Liquor and tobacco taxes	195	9.5
Poll taxes	3	0.2
Other taxes	128	6.2
Total tax revenues	$2,048	100.0

[a] Source: *Facing the Tax Problem*, New York, Twentieth Century Fund, Inc., 1937, pp. 534, 535.

considerations with respect to the tax systems of the state governments and the incidence of such taxes as are not already familiar from our previous discussion. The taxation of incomes follows much the same lines in state as in federal practice. The combination of personal and corporate income taxes and other corporation taxes produced 19.6 per cent of state revenues, so that these taxes were less than half as important in the state tax system as in the federal system. Income taxes are not applied in all the states, but in general our previous discussion of income taxation is applicable here. Some states, however, have recently adopted income taxes which provide that their citizens must pay a flat rate of 1 or 2 per cent on their entire incomes, or on incomes above a certain very moderate exemption. Such taxes are, of course, proportional in character and do not correspond to the theory of ability to pay. although they may be productive of large revenue.

General Property and Sales Taxes.—The general property tax is important and worthy of examination, but it will be treated in connection with the tax systems of local governments, where it assumes even greater importance than in state taxation. The sales tax has come into prominence in recent years as a source of revenue for state governments. The tax has been applied in about half the states, is based on retail sales, and usually runs from 1 to 3 per cent. It furnished 13.5 per cent of state tax revenues in 1936.

The sales tax is decidedly defective from the point of view of our principles of taxation. It is regressive in operation and does not conform to the principle of ability to pay. People with large incomes spend a smaller percentage of their incomes on the retail purchases subject to the tax than do poorer people, so that the tax takes a higher percentage of small than of large incomes. The sales tax is not so well received by the payers as some regressive taxes, for most of the sales tax laws require separate charging of the tax to retail purchasers, in order to promote the shifting of the tax to consumers and to make them conscious of the fact that they are paying the tax. The sales tax is costly to collect and not at all simple to administer.

State Inheritance Taxes.—The inheritance tax is about equally important for state governments as for the federal government. It is used in practically all states, and yielded 5.6 per cent of state tax revenues in 1936. In most states the tax is levied upon the several shares of an estate, rather than upon an estate as a whole —which means that it is truly an inheritance tax, and not an estate tax. Thus, the tax is often progressive in two directions. The rate grows larger the greater the share involved and the more distant the relationship, if any, between the decedent and the heir. The incidence of the state inheritance taxes is similar to that of the federal estate tax.

Motor Vehicle and Fuel Taxes.—The most important source of state tax revenue is the operation of motor vehicles. Most if not all states require the payment of a registration fee annually on all motor vehicles, while many collect additional sums for operators' licenses, and some have even imposed excise taxes on the purchase of new cars. Such excise taxes are paid once and for all, but the owners' and operators' fees are collected repeatedly. While these fees are not taxes, in the strict sense of the term, they have about the same effect as taxes on consumption or on the operation of businesses which will shift the taxes to the consumers. The same

is true of the motor fuel taxes—which are, for all practical purposes, taxes on gasoline. All of these taxes, therefore, tend to be regressive in operation. They yielded altogether some 37.7 per cent of state tax revenues in 1936.

In general, it may be said that gasoline has provided almost too tempting a source of revenue for the states. The first gasoline tax was adopted by Oregon in 1919. The revenue received from gasoline taxes increased from $5,400,000 in 1921 to $519,000,000 in 1936, so far as state governments are concerned, and to $972,000,000 for both state and federal governments in 1937. Annual average gasoline taxes per automobile increased from 51 cents in 1921 to $32.79 in 1937.[4] As long as the proceeds of the tax were used almost entirely for highway construction and maintenance, there was little protest against it. Now that many states have increased the gasoline tax sharply and are using the proceeds for any and all purposes, even including relief for the unemployed, it is becoming rather unpopular since it appears to discriminate against the users of motor vehicles

Other State Taxes.—The liquor and tobacco taxes levied by the state governments, which produced 9.5 per cent of state tax revenues in 1936, differ in no essential respects from the taxes applied to these products by the federal government. Poll taxes are quite negligible in so far as revenue is concerned. Their incidence is upon the individuals upon whom they are levied. The poll tax is a tax of a flat amount for each person, and would be most inequitable if it were not for the fact that the amount of the tax is ordinarily very slight. In addition to the general types of taxes mentioned above, there are many others, peculiar to individual states or small groups of states, which yielded 6.2 per cent of state tax revenues in 1936.

State Tax System as a Whole.—The states, like the federal government, have had great difficulty in making ends meet under their present tax systems, and have become involved in borrowing operations. In 1936, as in other years, three-fourths or more of state tax revenues were derived from taxes which do not conform to the principle of ability to pay. This means that the revenue systems of the states are highly regressive in operation, and that the burden of state taxation falls relatively more heavily upon the poor than upon the rich. The need for replacing sales taxes and

[4] *Chicago Tribune,* February 25, 1938.

other regressive taxes with income taxes and other progressive taxes is obvious.

City Revenues

We shall use figures for cities of 100,000 or more inhabitants, in 1935, in describing the sources of revenue for local governments. We see from Table 11 that these cities in 1935 received 67 per cent of their revenues from taxation, and largely from the general property tax which produced 60.2 per cent of total revenues and 89.9 per cent of tax revenues. With the exception of the taxes on

Table 11.—Sources of Revenue for Cities of 100,000 or More Inhabitants, Fiscal Year 1935

Source of Revenue	Amount Received (in millions)	Per Cent of Total Revenue
General property tax	$1,758	60 2
Special property tax	5	0 2
Other special taxes	17	0.5
Business and non-business license taxes	174	6 0
Poll taxes	2	0 1
Other revenues[a]	965	33.0
Total revenues[b]	$2,921	100 0

[a] Includes special assessments, fines, forfeits, and escheats; subventions and grants; donations, gifts and pension assessments, rents, interest, and highway privileges, earnings of general departments, and earnings of public service enterprises.

[b] Source: Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States, 1937*, Washington, Government Printing Office, 1937, p. 224

property, there is nothing new in the list of city taxes. The poll taxes are, of course, similar to those of the state governments, and so are the business and non-business license taxes. Non-business license taxes, such as dog taxes, fall directly on the consumer, while the business license taxes, such as those paid by operators of barber shops and billiard emporiums, fall upon producers, add to costs of production, and tend to be shifted to consumers in whole or in large part. Hence, these taxes are similar to excise taxes in their incidence, merits and defects.

The General Property Tax.—Since the tax systems of city governments are well-nigh completely dependent on the general property tax, it will be well to analyze that tax carefully. The general property tax is a tax on property considered as a homoge-

neous whole, and is sometimes called the "uniform rule" of taxation. This means that the rate of the tax is to be uniform throughout the taxing district and for any amount of property. The tax is based upon the valuation or assessment of property in terms of money. These valuations are estimated by assessors at specified times, and the tax is applied at a certain rate, ordinarily upon the total valuation of the property of the taxpayer in question. Boards of Review are often created for the purpose of correcting inequalities and obtaining a uniform basis of assessment.

Defects of the General Property Tax.—The general property tax is based upon the assumption that ability to pay is adequately represented by the ownership of "general property." The defects of the tax are numerous. In the first place, it is based on a mistaken notion as to the nature of property. Property is an institution which guarantees to the individual the right to use and control, to receive benefit from the ownership of, to exclude others from the use of, and to pass on to others at the time of death or before, whatever economic goods he may acquire. What is called "property" under this tax is in reality made up of two classes of things—wealth and claims upon wealth. Now when certain items of wealth and claims on these same items are both regarded as general property subject to tax, it is clear that double taxation arises. Thus, the corporation is taxed upon certain items of wealth, such as buildings and machinery, and the stockholder is taxed upon his shares of stock, which are the claim upon these articles of wealth. This is double taxation in the worst sense because it is largely if not entirely unintentional, and because an item of wealth and a claim upon that wealth are both taxed at the full rate charged other items of wealth which are not represented by similar claims. In the second place, it is assumed, at least by inference, that nothing other than "property" represents ability to pay taxes. This is clearly untrue at present, for many persons have very large incomes derived from personal services, but possess little wealth that is reached by the general property tax.

A third and important defect of the general property tax is that it is grossly inequitable. The assessment is made by assessors, who are ordinarily dependent for their positions upon some of the people whose property is to be assessed. They are for the most part untrained and inexperienced, and do their work in a relatively short time. The result is inequitable valuation and taxation. Much intangible property (that is, claims upon wealth) escapes assess-

ment altogether, while real and tangible personal property is assessed in a most discriminatory fashion. As expenditures have increased on the part of the governmental units dependent upon this tax, it has been found necessary to increase the rate at which the tax is applied. This has given to the owners of intangibles an increased incentive to evade assessment, which means a smaller amount of property of this kind assessed and a still higher rate, which in turn stimulates further evasion, and so on. Evasion of the tax is easy on the part of owners of intangibles, because their correct assessment depends so largely upon the cooperation of the taxpayer himself.

Though in theory the tax is based upon proportion (that is, the same rate being intended to apply regardless of the amount of property an individual has), it seems altogether fair to say that the tax has been regressive in its operation. The owners of great wealth are able to consolidate much of their holdings in forms which escape the tax, while it is well known that real and tangible personal property is progressively under-assessed. Thus, the rate actually paid upon "general property" tends to be the lower, the greater the amount of property possessed by the individual. In addition, it becomes more and more difficult as time goes on to insure the fiscal adequacy of the tax, for it is not easy to adapt the tax to increasing fiscal needs. It is decidedly inelastic.

Classified Property Taxes.—In some states and local governmental units attempts are made to avoid the difficulties arising under the general property tax by adopting what are called "classified property taxes." As the name suggests, the various items of wealth and claims upon wealth are divided into classes for purposes of taxation, with a different rate of taxation for each class. The purpose is to obtain a more equitable distribution of the burden of taxation and, of course, to make possible the more efficient administration of the taxation of property. The tax rate applied in each class is high or low, depending chiefly upon whether the items in the group can easily evade assessment and taxation. The lowest rate is accordingly applied to intangible personal property for the above reason and in order to avoid any serious double taxation. Tangible personal property is less mobile than intangible, but there are nevertheless means of evasion open for such items of wealth. Consequently, a moderate rate is usually applied in this group. Least mobile and least likely to evade taxation is real

property, and the highest rate of all is imposed upon wealth of this type.

Improvement of the General Property Tax.—Many suggestions might be made for improving the general property tax. The assessors should be appointed rather than elected, and the county should be the unit of assessment, with the whole procedure under state supervision and control. The collection of the tax should be improved, with delay allowances, and the remission or reduction of penalties, eliminated. The interest penalty for delay in payment should be two or three times the current rate on real estate loans, in order to prevent borrowing from the government through non-payment of taxes. No further exemptions from the tax should be granted for the purpose of attracting business enterprises to a community, and a reassessment of "properties" should be made oftener than at present. Constitutional limits on tax rates might well be repealed, and the tax should be used only to supply revenue for the local units of government.[5]

The Incidence of the General Property Tax.—It is not feasible to discuss the incidence of this tax as a whole. It must be considered as it falls upon owners of different kinds of wealth. In so far as the general property tax is a tax on land, the tendency is strong for the burden to rest finally upon the owner of the land, regardless of whether he pays the tax originally. Land is not a commodity produced at the will of man, but is fixed and non-extensible in amount, for all practical purposes. The rent of land, and consequently its value, are determined by the conditions of demand for and supply of land. There is nothing about a tax on land which will make its user willing to pay a higher rent for it, nor will its supply be affected in any way by such a tax as is ordinarily applied. Therefore the tendency is for the owner of land to bear the burden of any tax placed on it. It should be remembered that this is the case stated in its bolder terms. Many qualifications and variations of assumptions have been made in the past in presenting the theory of the incidence of the tax on land, but in the majority of the cases which are of practical importance the tendency as stated above is clearly observable.

The incidence of the tax tends to be quite different when it falls on buildings, rather than land itself. A tax on buildings tends to fall upon the tenant rather than on the owner, unless these two happen to be the same person. Buildings are simply one form of

[5] These recommendations are from *Facing the Tax Problem,* already cited.

the investment of capital, and if a tax is imposed which temporarily falls upon the owners and makes the return from this investment smaller than that which can be obtained in other lines, the tax tends to be shifted. The process of shifting is a long-run process, and comes about through an exodus of capital from the taxed form of investment, which enables the capital that remains in this line to receive as high a return as it received before the imposition of the tax.

A tax on buildings, then, seems to be merely one case of the taxation of capital. In so far as a tax falls upon some lines of investment and not upon others, or upon some more heavily than upon others, there is a tendency for the tax to be shifted through the process outlined in the preceding paragraph. In so far as a tax affects all capital alike, its shifting or non-shifting depends upon whether, in the long run, the tax is sufficiently high to operate as a check upon saving and the accumulation of capital. This possibility has already been discussed in connection with the criticisms of progressive taxation. To the extent to which the general property tax is imposed on articles of wealth which will be used not as capital in further production but merely for personal consumption, the prospect of shifting the tax is practically nil, because such articles do not ordinarily enter into later price transactions.

Conclusion.—In referring to the combined taxation systems of federal, state and local governments, it is necessary to admit that taxation on the whole in the United States is regressive in operation and does not conform satisfactorily to the principle of ability to pay. In other words, by far the larger part of our total tax revenue is received from taxes which take a larger *percentage* of small incomes than of large incomes. The progressive taxes of the federal government are not adequate to make the entire federal tax system progressive in operation. The states depend largely for tax revenue upon the general property tax and what might be called a system of excise taxes, and both are regressive in operation. Similarly, the local governments, as studied here, are very largely dependent upon this same general property tax.

It follows that, according to our principles of taxation, much of the revenue which is now being raised by regressive taxes might better be obtained by progressive taxation, if true ability to pay is to be our basis for the distribution of the tax burden. It also follows that further increases in tax revenue, when necessary, should be obtained by a further application of progressive rates

whenever possible, despite all protests against "soaking the rich," and not by an extension of those forms of taxation which are regressive in operation. Similarly, if the need for tax revenue should lessen, the regressive taxes should be eliminated or sharply reduced in severity, instead of cutting the rates now applicable to incomes, excess profits, and inheritances. Every attempt should be made to increase the effective operation of these progressive taxes.

It is true that most of the regressive taxes are fairly satisfactory from an administrative point of view, since they are usually certain, convenient, and economical in collection. It is true, also, that when more revenue is needed in depression—a time when excess profits are but a memory and everyone's income is greatly reduced—it may be necessary to extend the use of excise, sales, or other taxes *as a temporary expedient.* But they should be clearly recognized as emergency measures, and not accepted as permanent changes in our system of taxation.

The revenue system of the federal government is ordinarily capable of producing abundant revenue, but state and local systems are less satisfactory from the point of view of adequacy. Moreover, it is unsatisfactory for both federal and state governments to tax both incomes and inheritances. Indeed, it might be desirable to have only one tax system in the United States. Under such a system, all taxes would be collected by the federal government and the revenue divided among the various governmental units. Finally, if regressive taxes were largely eliminated, it would be desirable to extend the income tax downward until practically everyone with an income would make some contribution, however small, to the support of the government, and would be aware that he was making such a contribution. This might aid in bringing about a public understanding of the relation between the performance of functions by the government and the necessity of contributing to the support of the government, and thus help to correct the present unwholesome, careless attitude toward public funds.

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1. What is the nature of taxation, and how is taxation related to public expenditures?
2. What is the problem of taxation?
3. What is the prime test of a sound tax system?
4. If a tax system meets this test, what is the next most important consideration? Why?

5. What are the other requisites of a sound tax system?
6. Why is the principle of ability to pay considered superior to other principles as a basis for distributing the burden of taxation?
7. What is at present the most generally accepted indicator of ability to pay? Why?
8. Does taxation according to ability to pay point to regressive, proportional, or progressive taxation? Explain.
9. What is meant by equal sacrifice, least aggregate sacrifice, and net utility of income?
10. State and criticize the objections to progressive taxation.
11. Distinguish between direct and indirect taxes.
12. List the principal sources of federal revenue.
13. What are the principal characteristics of the personal income tax as applied by the federal government?
14. Comment on the merits and defects of our federal personal income tax.
15. Is the personal income tax a direct or indirect tax? Why?
16. Describe the federal corporate income tax. Why do some people object to this tax? Explain.
17. Does this tax lead to double taxation? Why?
18. Is double taxation always objectionable? Why?
19. Describe the controversy of recent years over the taxation of the undistributed earnings of corporations.
20. Compare the 1938 tax on the undistributed earnings of corporations with the 1936 tax of that type.
21. What is the nature of the new federal tax on additions to corporate surpluses?
22. Do you consider this tax to be desirable? Why or why not?
23. Explain how the capital stock tax and excess profits tax work in combination.
24. How does the federal government tax inheritances? Explain. State and answer the chief objections which are raised to the federal estate tax.
25. What are excise taxes and who bears their burden? Explain.
26. Are excise taxes desirable in themselves? Why?
27. Comment on the importance and desirability of customs duties in our federal tax system.
28. Criticize the federal tax system as a whole.
29. Describe the principal sources of state tax revenue and criticize state tax systems as a whole.
30. What is the sales tax and how is it used? Is it a desirable tax? Explain.
31. What are the principal sources of city revenues?
32. In what respects is the general property tax defective? What steps

may be taken to avoid the difficulties which have been experienced with this tax?

33. What is the incidence of the general property tax? Explain.
34. How does the combined tax system of federal, state, and local governments measure up to the tests of a sound system of taxation? Explain.

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PROBLEMS OF ECONOMIC STABILITY

9 PRICE LEVELS

THE FINANCIAL PAGES OF OUR METROPOLITAN NEWSPAPERS, IN REPORTING THE DAILY TRANSACTIONS ON THE NEW YORK STOCK Exchange, ordinarily list stock market prices for a given day under four headings—"open," "high," "low," and "close." This is evidence that stock prices fluctuate even during the limited trading period of a single day. However, these fluctuations do not conform to a general pattern, and they are largely unpredictable. In this respect, stock prices differ from certain other prices in which the changes, though they may be frequent, exhibit a certain general tendency. Commonest among this type of prices are those whose fluctuations follow a seasonal pattern. For example, throughout the period 1916 to 1929, inclusive, the wholesale price of calves reached a yearly "high" in September, and then fell fairly steadily to a yearly "low" which, in all but two years, occurred in either April or May. From this spring low, it again rose gradually to the September high. Thus the general direction in which the price of calves might be expected to move within the year was predictable with a fair degree of accuracy.

Some prices, instead of fluctuating frequently, are surprisingly rigid. Many products of the iron and steel industry fall into this category. For example, the price of open-hearth steel rails and wrought iron pipe has remained unchanged for periods exceeding five years. We are thus forced to the conclusion that individual prices may be either highly flexible or highly inflexible, some varying apparently at random and others according to a general pattern.

The Nature and Extent of Price Fluctuations

Index Numbers of General Prices.—However, despite these differences in individual price movements, it is possible to speak of a *general price level*. This term refers to the general average of all prices prevailing at any given time—though in discuss-

ing the statistical determination of the price level we shall find that the phrase "all prices" is, in practice, subject to certain qualifications.

Price levels are customarily expressed, and changes in price levels are measured, in terms of "index numbers." Index numbers of the general price level are constructed by, first, choosing a *base year*, in which the total of the prices included in the index is given an arbitrary rating of 100. Then, after finding the totals of prices of the same goods for earlier and later years, an index number is given to each of those years which bears the same relationship to 100 as the total prices for each of the years bear to the total for the base year.

Index Number Problems.—There are two main problems involved in the construction of an index number. There is, first, the selection of a year to serve as a base year. Since the index numbers for all years are compared with that of the base year, which is always expressed as 100, and since, further, it is customary to think of an index number greater than 100 as reflecting prices above normal, and one less than 100 as indicating prices below normal, it is desirable to choose as a base year one in which prices were neither abnormally high nor abnormally low. Many of the current price indexes use 1926 as a base, since that year fell approximately midway between the low point of the post-war depression and the high point of the boom in the late 'twenties.

The second problem relates to the items to be included in the calculation. Considered in the abstract, the price level is, as has been said, the average of *all prices*. From a practical standpoint, however, the construction of an index number based on all prices would constitute an almost, if not completely, impossible task. Hence, it becomes necessary to select certain specific prices, the movements of which may be regarded as reflecting with a fair degree of accuracy the movement of prices in general.

Wholesale commodity prices constitute a fairly good basis for a price index, for accurate wholesale quotations are more readily available than accurate retail prices, and they vary less than retail prices. The widely used monthly price index of the United States Bureau of Labor Statistics is based on the wholesale prices of nearly eight hundred commodities. An index more nearly representative of *all* prices, however, may be secured by including

security prices, wages, retail food prices, rents, transportation costs, and other prices. Such an index is in fact computed by Dr. Carl Snyder, and is widely used.

Weighted Index Numbers.—One further difficulty should be noted at this point. Any index based upon a large number of items is certain to include some commodities that are much more widely used than others included in the calculation. Hence, if index numbers are to indicate accurately the significance of price changes, they must reflect the more extensive use of these particular commodities. A change in the price of eggs, for example, might be expected to have a more direct and widespread effect than an equivalent change in the price of Xmas cards. This difficulty may be overcome by the process known as weighting. This means multiplying the individual prices by the quantity of the product sold annually. The aggregate of these prices in the base year is then given the value 100, and the index numbers of the other years bear the same relationship to 100 as their aggregate prices bear to those of the base year. An index so computed is called a weighted index.

The construction of price index numbers is shown in the following examples:

TABLE 12.—CONSTRUCTION OF UNWEIGHTED INDEX NUMBERS

The aggregate prices for 1926, which has been selected as a base year, are assigned a value of 100. The index for 1938 is obtained by dividing the aggregate of prices for that year ($3.40) by the aggregate for the base year ($4.93) and multiplying the result by 100.[1]

Commodities	Price per Unit	
	1926	1938
Wheat (per bu.)	$1 24	$1.10
Butter (per lb)	41	.30
Fuel oil (per bbl.)	1 47	.90
Raw wool (per lb.)	1 16	.70
Tin (per lb.)	.65	.40
Aggregate prices	$4 93	$3 40
Unweighted index	100	69

[1] It is evident that the same result may be obtained by first multiplying $3.40 by 100, and then dividing by $4.93.

Extent of Price Level Fluctuations.—An idea of the extent of price level fluctuations may be gathered from Table 14, which gives the index of wholesale commodity prices, prepared by the Bureau of Labor Statistics, for the years 1910 to 1937, inclusive.

TABLE 13.—CONSTRUCTION OF WEIGHTED INDEX NUMBERS

The process here is the same as that in Table 12, except that the aggregate prices are obtained by first multiplying the unit price of the commodity by the quantity sold.[2]

Commodities	Units Sold Annually	1926		1938	
		Unit Price	Total Price	Unit Price	Total Price
Wheat (per bu.)........	40,000	$1 24	$ 49,600	$1 10	$ 44,000
Butter (per lb.)	140,000	.41	57,400	.30	42,000
Fuel oil (per bbl.).......	25,000	1.47	36,750	.90	22,500
Raw wool (per lb.)......	15,000	1.16	17,400	.70	10,500
Tin (per lb.)...........	40,000	.65	26,000	.40	16,000
Aggregate prices........			$187,150		$135,000
Weighted index			100		72

TABLE 14.—BUREAU OF LABOR STATISTICS WHOLESALE PRICE INDEX, 1910–1937
(Base year—1926)

Year	Index	Year	Index
1910	70	1924	98
1911	65	1925	104
1912	69	1926	100
1913	70	1927	95
1914	68	1928	98
1915	70	1929	95
1916	86	1930	86
1917	118	1931	73
1918	131	1932	65
1919	139	1933	66
1920	154	1934	75
1921	98	1935	80
1922	97	1936	81
1923	101	1937	86

[2] It will be noted that identical weights are used for both years. Of course, the relative importance of various commodities may vary from year to year. If so, and if the weights are changed as a consequence, the process of constructing a weighted index number becomes slightly more complicated, since it is then necessary to deal with averages instead of aggregates.

Limited Implications of Price Level Changes.—It should be clear from our comments on the behavior of individual prices that a change in the general price index does not necessarily indicate a corresponding, much less a proportional, change in *every* price, or, indeed, in every price entering into the calculation of the index number in question. Certain prices are relatively inflexible, and such prices not only show a surprising ability to resist the pressure of general price trends but also operate to reduce the extent of the general price level movement. For example, the wholesale commodity index fell from 104 in 1925 to 73 in 1931, but the price of open-hearth steel rails remained unchanged at $43.00 per long ton. We have noted, also, that certain prices follow a seasonal pattern. In such cases a seasonal increase may be sufficiently great to more than offset a general downward price tendency.

On the other hand, the pressure of a general price movement may be strong enough to destroy the seasonal pattern ordinarily reflected by certain individual prices. For example, we have already noted that, throughout the period 1916 to 1929, the wholesale price of calves rose from an annual "low" in either April or May to an annual "high" in September, with remarkable regularity. However, the great depression, beginning late in 1929, exerted such pressure as to destroy this pattern completely. The price of calves fell almost without interruption from January, 1930, to November, 1932, with the result that in the three years from 1930 to 1932, inclusive, the annual "high" occurred in either January or February, and the "low" was reached in either November or December.

General Prices and Purchasing Power.—The price index is the best indication we have of the purchasing power of money. Obviously, when the general level of prices is high, a given quantity of money buys a smaller amount of goods than it would buy when general prices are lower. The index of purchasing power is, indeed, the reciprocal of the index of prices, and is derived from the latter according to the following formula:

$$\frac{\text{Price index of the base year}}{\text{Price index of the given year}} \times 100 = \begin{array}{c}\text{Purchasing power index}\\ \text{for given year}\end{array}$$

Thus in 1937, when the wholesale commodity index was 86, the index of purchasing power was 116.[3]

[3] $\frac{100}{86} \times 100 = 116.$

The distinction between the purchasing power of a given amount of money and the total national purchasing power at any given time should be clearly understood. The curves of production, employment, and wages generally bear a fairly direct relationship to the curve of prices. When prices are high, the quantity of money and credit in circulation, and the velocity at which they circulate, are also high. Consequently, the *total national purchasing power* may be great when the *purchasing power of the dollar* is low. It is only the latter, therefore, which can be said to vary inversely with the general level of prices.

The Equation of Exchange.—Over any given period of time, a certain *volume of trade* is carried on—that is, a certain number of exchanges take place, an exchange occurring whenever an article is bought or sold. Many of these exchanges are transacted by means of money. But at the present time credit plays a more important rôle in economic activity than money, so that many of these exchanges are transacted by means of credit. We should remember, then, that both *money* and *credit* may be used to transact exchanges, and that each unit of money or credit may be employed many times in a given period of time. The number of times a unit of money or credit is thus used is termed its *velocity of circulation.* Since money and credit are not desired for themselves, but rather as a means to the acquisition of economic goods, it may be assumed that the total amount of money and credit in existence at any given time will be fully employed in exchanging for the total quantity of goods available.

Hence, it follows that prices at which these goods exchange depend upon the relationship between the quantity of money and credit in circulation, the velocity of their circulation, and the volume of trade. This relationship may be expressed in a formula, known as the *equation of exchange*, which is as follows:

$$P = \frac{MV + M'V'}{T},$$

in which P represents the price level; M, the quantity of money in circulation; V, the velocity with which M circulates; M', the quantity of credit in circulation; V', the velocity with which M' circulates; and T, the volume of trade. Other factors remaining unchanged, it is clear that the price level varies directly with changes in the quantity of money or credit, or in the velocity with which either circulates, and inversely with changes in the volume of trade.

There is a multitude of conditions, such as climatic changes, wars, population changes, technological progress, widespread industrial unrest, governmental legislation, and so on, which may conceivably exert an indirect effect upon the price level by altering the quantity of money or credit, the volume of trade, or the other factors in the equation. Their influence upon the price level will be felt, however, only because of their effect upon one or more of the factors in the equation, for the latter alone exert a direct influence upon the price level. For example, prices might be expected to rise in the wake of a widespread and disastrous drought, but the direct effect of the drought would be a smaller quantity of goods, and therefore a smaller number of exchanges. T in the equation of exchange would then fall, and this decline would tend to cause a rise in prices. Were it possible to conceive of a widespread drought which had no influence upon the volume of trade, we should have a situation in which the drought would bring no change in the level of prices.

Nature of Price Level Changes.—A glance at Table 14 reveals the fact that the general level of prices is subject to frequent fluctuations of considerable extent. Any important change in economic conditions almost inevitably results in at least a temporary lack of equilibrium, and its influence spreads throughout the economy as a whole. This disequilibrium is particularly acute when the change is one which could not be accurately anticipated and prepared for well in advance of its actual occurrence. We have seen that certain individual prices follow definite seasonal patterns with considerable regularity. However, the seasonal peaks and troughs of these several individual prices cannot be counted upon to coincide. Hence, they do not operate to produce a markedly seasonal pattern in the general level of prices. Moreover, whatever influence these seasonally fluctuating prices might have on the general price level might easily be more than offset by the influence of prices which have no such characteristics. The result is that the general price level follows no particular pattern, and fluctuates in a manner which cannot be predicted accurately for any considerable period in advance of the change.

Some Consequences of Price Level Changes

Price Level Changes and the Business Enterpriser.—We emphasize *changes in the price level* rather than the existence of either *high* or *low prices*, for whether prices are high or low is of relatively slight importance. Provided only prices remain rela-

tively stable, the economy as a whole can and will adjust itself to that level, whether it is high or low. Nor would price changes themselves exert a disturbing influence upon the individual if he were engaged simultaneously in the purchase and sale of goods the prices of which were all moving in the same direction and at the same rate. But in an era in which production is characterized by extreme roundaboutness, or indirectness, this is not likely to be the case. The producer often purchases his agents of production some months or even years in advance of the date on which he sells the finished product. In a period of steadily rising prices his purchases of land, labor, and capital will antedate considerably the sale of his product, and this purchase at a low price level and sale at a high will bring him an unusually large margin of receipts over costs. Conversely, however, when prices are falling steadily his costs are incurred at a point on the general price curve higher than that at which the product is sold. In this case the result will be a reduction in the normal margin of profit; or, if the decline in general prices is sufficiently speedy, or the productive process spread over a sufficiently long period, it may be that sales will have to be made at a loss.

Prices, Incomes, and Expenditures.—Since the price level is merely an average of prices, there will seldom be an exact correlation between the trend of a specific individual price and the movement of prices in general. The average individual spends his income for a wide variety of goods, so that fluctuations in general prices may represent at least a rough approximation of fluctuations in the amount of his necessary expenditures. His income, however, will ordinarily be secured largely or entirely from the sale of a single good, or relatively few goods, and will therefore be unlikely to fluctuate directly, and still less likely to fluctuate proportionally, with the general price level. Large numbers of people, for example, get their entire income from the sale of their labor power, payment being made in the form of a wage or salary. Thus their income depends solely upon the movement of the price of labor. The general level of prices may reflect with fair accuracy the fluctuations in their cost of living, but it is improbable that the curves representing the fluctuations in both general prices and the wages of labor will coincide. But any failure to do so will, of course, result in a change in the standard of living which the wage- or salary-earner is able to maintain. Should the general price curve fall more rapidly than the price of labor, he will experience an

increase in terms of real income. But should general prices rise more rapidly than wages, the ability to buy commodities and services, and therefore the worker's real income, will decline.

Price Levels and the Business Cycle.—We have said that general price changes would not affect the individual directly provided he were engaged in the simultaneous purchase and sale of goods, the prices of which were all moving in the same direction and at the same rate. But a situation of this kind seldom, if ever, exists. Hence, few if any members of society avoid the direct effects of price level changes. When the results of price movements are experienced at one time by an entire economic group, such as producers or wage earners, the national economy as a whole is profoundly affected. The consideration of price level changes as both a cause and a result of economic developments of national or international significance will be undertaken in the following chapter, which deals with business cycles. For the present, we restrict our inquiry to the direct effect of such fluctuations upon individuals or specific economic groups.

Price Levels and Wage Earners.—Producers ordinarily gain during periods of rising prices, and lose through declines in the price level. Wage earners and salaried workers are affected in a contrary manner. We are thinking of salaried workers as those who are paid on an annual or monthly basis, and of wage earners as those paid by the hour, day, or week. Members of both groups suffer a reduction in real income when the price level rises more rapidly than the price of labor, and enjoy an increase when general prices fall more rapidly than wages or salaries. We may go further and observe that there is a general tendency for changes in the price of labor to lag behind changes in the price level, whether the latter is rising or falling. Changes in the price level cannot be accurately predicted, and hence wages and salaries are altered as the result of, rather than in anticipation of, general price changes. Salary commitments are made over a longer period than wages, and are therefore less flexible than wage rates. Consequently, though individuals in both of these groups gain when prices are falling and lose when prices are rising, the effect upon the salaried worker is proportionately greater in either case, since it takes longer to make adjustments in salaries than in wages.

Our observations about the gains or losses that result from price level changes, and affect wage earners and salaried workers, are based upon the relationship between their money incomes and

the cost of living. These observations assume, therefore, that the persons under consideration are receiving income continuously—that is, that they are steadily employed. But the fact is that a period of falling prices is disadvantageous to the business enterpriser, and that production (and consequently employment) is generally curtailed during such a period. Therefore, our conclusions must be somewhat modified. It is true that the wage earner or salaried worker gains in periods of falling prices *provided he remains employed.* However, in such times unemployment may be so extensive that wage earners and salaried workers, as a group, will experience a reduction in their *aggregate real income.* On the other hand, though those who are continuously employed suffer a reduction in real income when prices are rising, the aggregate of real wages or salaries paid out may show an increase during these periods. This is possible because rising prices are so advantageous to enterprisers that business men tend to increase both production and employment when prices are on the upgrade.

Price Levels and Fixed Incomes.—The individual wage or salaried worker is affected by price level changes because the price of labor, as compared with general prices, is relatively sluggish. It follows that those persons whose money incomes are completely inflexible will be affected to an even greater degree. In this category would be included those who live on the income from bonds, annuities, pensions, and the like. In all such cases the amount of money income is definitely fixed, and fluctuations in the cost of living are in no part offset by compensatory changes in money income. The result is that this group reaps full benefit from price declines (unless something interferes with their getting the payments agreed upon), but must bear the full burden of price increases.

Price Levels and Debtor-creditor Relationships.—Obligations incurred by debtors are also fixed in terms of money. When the debtor borrows a given sum of money he is, in effect, securing possession of a quantity of purchasing power. His future obligation to the creditor, however, is expressed in terms of the given number of dollars received, plus an additional sum representing interest. If the general level of prices is higher when the loan is repaid than when it was made, the specified number of dollars involved in the transaction will have lost a part of their ability to command goods. The debtor thus gains and the creditor loses, for a smaller amount of *purchasing power* is repaid than was

borrowed. But if it is lower at the time of repayment, the situation is reversed, and the debtor loses while the creditor gains. Of course, the decline in the price level may make it impossible for the debtor to pay his obligations, in which event the creditor also loses.

Farmers often find it necessary to borrow at crop-planting time, and do so with the intention of paying off their loans after the harvest. A decline in the general price level, accompanied by a drop in the price of the products raised, would make it very difficult for these farmers to meet their obligations. Let us suppose, by way of illustration, that a wheat grower finds himself in a position to borrow $500 at five per cent interest. With this sum he can purchase fertilizer which he estimates will increase the yield on his land by 650 bushels. Wheat is selling at 90 cents a bushel. Under these circumstances, it would seem advantageous to borrow the money. However, by the time the crop is harvested the general price level has declined and the price of wheat has fallen to, let us say, 75 cents a bushel. It is clear that the value of the additional yield secured through the application of the fertilizer is insufficient to repay the loan.

Our contention that a period of falling prices is advantageous to the creditor is subject to certain qualifications. It is true that a fall in the price level will bring the creditor, upon the maturing of the debtor's obligation, a larger volume of purchasing power than that originally advanced. But this is true, of course, only if repayment is actually made. Since, however, a period of falling prices means reductions in gains, and frequently definite losses to business enterprisers, a creditor may find that the fall in the price level has brought bankruptcy to his debtor and made the collection of the debt impossible. Rising prices, on the other hand, though they mean the return of a smaller amount of purchasing power than was borrowed, also lessen the possibility of default on the part of debtors.

Proposals for Stabilizing the Price Level

Desirability of Price Stability.—Among the theories that have been advanced in explanation of the phenomenon known as the business cycle, are those which suggest that the causes of cyclical fluctuations in business lie almost exclusively in changes in the price level. In so far as the stabilization of general prices would result in general economic stability, which would in turn

tend to minimize the frequency and severity of cyclical fluctuations, such stabilization is unquestionably desirable. However, an adequate discussion of the business cycle involves the consideration of factors other than prices, and this discussion is reserved for the following chapter. But, as we have seen, a lack of general price stability has adverse effects upon significant groups, quite apart from its relation to the larger problem of the business cycle. In the interests of wage earners and salaried workers, business enterprisers, creditors, debtors, and others who face the ever-present danger of loss through unpredictable price level changes, it is highly desirable to find, if possible, some means of minimizing these fluctuations, or of neutralizing their unpleasant consequences.

Our discussion of the equation of exchange indicated the important rôle which the quantity of money and credit in circulation plays in the determination of the general price level. It is natural, therefore, that proposals designed to stabilize prices should concern themselves largely with attempts at *monetary stabilization*—that is, with various devices by means of which the quantity of money and credit in circulation might be regulated, or managed, primarily by governmental action. A glance at the equation of exchange shows that complete price stability cannot be achieved merely by keeping the quantity of money and credit unchanged, but requires a continuous adjustment in the quantity of M and M', so as to offset the influence of changes in the volume of trade (T in the equation) upon the price level.

It is doubtful whether *complete* and *permanent* price level stability is desirable. Our economy has, for a considerable period, been characterized by a steady and continuous increase in technological efficiency. One of the principal and inevitable consequences of technological progress has been a reduction in the costs of production. If permanent price level stability were to be maintained in the face of steadily declining costs, the result would be an increase in profits to an extent which might eventually prove as harmful to a balanced economy as present price fluctuations. Hence, it might be desirable to "manage" the monetary system, so that the price level would decline gradually and thus keep pace with decreasing costs. This would substitute for the present price changes—which are sudden, frequently severe, and generally unpredictable—a slow but steady trend, progressing in a definitely predictable direction, and at a rate that could probably be predicted with a considerable degree of accuracy. Proposals for achieving

price stability might be employed, then, either to maintain an absolute stability or to bring price movements into accord with the long-run curve of declining production costs.

The "Compensated Dollar."—A proposal known variously as the "compensated dollar," "stabilized dollar," and "commodity dollar," has Professor Irving Fisher as its leading advocate. Our present dollar is defined as a specific amount of gold of a given degree of fineness. We have seen that a rise in prices means a fall in the purchasing power, or value, of the dollar. A decline in the value of the dollar represents, in effect, a fall in the value of gold in relation to other commodities for which the dollar is exchanged. The compensated dollar plan proposes to stabilize prices by adjusting the *gold content* of the dollar in accordance with fluctuations in the purchasing power of gold. Of course, frequent variations in the gold content of the dollar would be impracticable, so long as gold was in actual circulation. Consequently, it is proposed to withdraw gold coin from circulation, and to substitute a circulating media consisting of gold certificates. What would actually be subject to alteration would then be the amount of gold bullion which a gold certificate would command at the mint.

We may illustrate the manner in which the plan would presumably work. Let us assume an increase in the general price index from 100 to 110. This rise would indicate that sellers are, on the average, demanding for their goods ten per cent more money—that is, ten per cent more gold—than formerly. If, therefore, the gold content of the dollar were to be increased by ten per cent, these sellers would get the amount of gold they demand, and without increasing the number of dollars (that is, the price) that buyers are required to pay. The index of prices, if expressed in terms of gold, would remain ten per cent above the previous level, but if expressed in terms of numbers of dollars it would decline to the original level. We may assume that a fall in prices indicates a willingness on the part of sellers to accept a smaller amount of gold in exchange for their goods. Under the compensated dollar plan, a decrease in the gold content of the dollar would enable sellers to secure the same number of dollars as was previously paid them, and, at the same time, would not require buyers to part with gold in excess of the amount demanded by the sellers.

In terms of the equation of exchange, this plan would undertake to achieve stability by varying the quantity of money in circulation. This is true, since any increase in the gold content of the

dollar would reduce the dollar value of the government's gold reserves, and, therefore, the quantity of gold certificates that could be circulated. A contraction of the currency would follow, and this would result in decreasing prices. A decrease in the gold content of the dollar, on the other hand, would increase the quantity of gold certificates that would be circulated, and there would follow an expansion of currency with a simultaneous increase in the price level.

Since the compensated dollar plan relies solely upon variations in the quantity of money in circulation to achieve price stability, the extent to which it might be expected to succeed would seem to depend upon the directness of the relationship between the quantity of money and the quantity of credit. We are aware of the present importance of credit. We know, however, that credit is based upon and limited by existing stocks of gold reserves. If it were certain that alteration in the quantity of money would produce an immediate, direct, and proportional change in the quantity of credit, we should be warranted in saying that price stability could be maintained through the control of money. But it seems reasonably certain that, in the short run at least, the volume of credit may vary considerably without corresponding changes taking place in the volume of money. Hence, it would appear that the compensated dollar could achieve price stability only if it were supplemented by control over the quantity of credit in circulation.

It will be seen that the plan depends upon a price index number to indicate the nature and extent of changes to be made in the gold content of the dollar. We have seen that certain subjective elements of judgment enter into the construction of an index number—there is, for example, the question of which prices are to be included and which excluded. Since the inclusion of all prices is a practical impossibility, an index number is at best merely a more or less successful approach to an accurate measure of price level fluctuations. The success of the compensated dollar plan would inevitably be limited by inaccuracies in the index number upon which it was based, and therefore the plan would of necessity fall short of perfection in its actual operation.

Stability Through Credit Control.—Efforts to bring about price stability may be based primarily upon the control of credit. We already have in this country, in the form of the Federal Reserve System, machinery for exercising a control over credit

which has not yet been fully utilized. The nature of this machinery was described in an earlier chapter, and need merely be summarized at this point. Prior to 1933, reliance was placed chiefly upon the ability of the Board of Governors of the Federal Reserve System to control credit by advising Federal Reserve banks to change rediscount rates and engage in open-market operations. But the use of these devices has proved rather disappointing in the prevention of overexpansion of credit, and has had still less success in checking undue contraction of credit.

It remains to be seen how effective will be the new powers granted by the Banking Acts of 1933 and 1935—particularly the power to change legal reserve requirements. There is reason to believe that the intelligent use of these powers should strengthen in particular the ability of the System to halt overexpansion. However, the psychology of the business community, as it affects both bankers and industrial producers, plays a very considerable part in determining the supply of and demand for credit; so that there is reason to doubt that the devices now provided by the System can be highly successful in holding the volume of credit within narrow limits. In an effort to meet this psychological difficulty, it has been proposed that privately owned banks be made to restrict their activities to safeguarding funds and facilitating their transfer by check, and that the power to create credit be intrusted solely to governmentally owned banking institutions.

Price Control vs. Price Freedom.—Whatever the devices used to control credit, and wherever the power to create credit may reside, the fact remains that it would be an almost superhuman task to determine the precise moment at which credit control should be exercised. For this reason some persons feel that disturbances created by the free functioning of an automatic price system are preferable to possible consequences of attempted control of the price level by political agencies. Past experience has shown that such attempts have sometimes aggravated existing difficulties, instead of alleviating them. On the other hand, to abandon all hope of exercising conscious control over economic phenomena is to adopt an unnecessarily fatalistic attitude. We cannot undertake here to compare the relative merits of economic planning and economic automaticity, but it is clear that this broad issue is involved in any comprehensive proposal to stabilize the price level by interfering with its free and "natural" movement.

The Alleviation of Evils of Price Level Changes

Multiple Standard of Deferred Payments.—Thus far, we have considered two plans that have been suggested for attaining stability in the general price level. There are two other distinct types of proposals for handling the problem of fluctuations in general prices. First are plans which do not seek to bring about price stability, but rather to eliminate the objectionable consequences of instability, at least in so far as certain specific groups of persons are concerned. An example of this type is the multiple standard of deferred payments. Secondly, there are devices designed to achieve at least a relative stability in the prices of a particular group of commodities, rather than in the general price level as a whole. Certain recent proposals and legislation in the field of agriculture represent examples of this type.

At present, the extent of a debtor's obligation is determined by the number of dollars he has borrowed. The multiple standard of deferred payments would have the obligation expressed in terms of purchasing power. This would mean that when the debt matured, the debtor would not necessarily repay the creditor the actual number of dollars borrowed, but instead whatever number of dollars represented, *at the time of repayment,* an amount of purchasing power equivalent to the purchasing power which was transferred from creditor to debtor at the time the loan was made. An index of purchasing power would be used to determine the exact number of dollars to be paid back. For example, our wholesale commodity index shows that the purchasing power of $1000 in 1920 was equivalent to that of $650 in 1926. Consequently, if this price index were used, an individual who borrowed $1000 in 1920 would be required, under the multiple standard of deferred payments, to repay in 1926 not $1000 plus interest, but only $650 plus interest on the $1000 borrowed.

Because it is based upon an index number, this proposal is open to an objection that we noted in connection with our discussion of the compensated dollar. Two further difficulties may be mentioned. First, it is impossible to predict just what the index of purchasing power will be at any given future date. Consequently, the debtor could not know in advance the exact number of dollars he would have to accumulate in order to meet his obligation. Hence, he would find it difficult to arrange a plan of saving which would enable him to acquire a sufficient sum to pay off, at the appointed

time, his *indefinite* obligation. Secondly, this plan would have to be based on the general index of purchasing power, derived from the index of general prices. We have seen, however, that individual prices may move in a direction opposite to the trend of the general price level. In a previous illustration, we saw that a wheat farmer might find it difficult to repay a loan, under present conditions, if the price of wheat should fall as the result of a general downward movement of prices. Let us assume, however, that the multiple standard of deferred payments is in effect, and, further, that the price of wheat has fallen in the face of a rising general price level. Because of the rise in the price level, the farmer would be required to repay an even larger number of dollars than he had borrowed, and his difficulties would be increased rather than diminished. In short, this proposal might prevent creditors or debtors *as a class* from gaining or losing through general price changes, but *as individuals* their losses might be aggravated or their undeserved gains increased.

Stabilization of Farm Prices.—The Farm Act of 1938 rests upon the assumption that, with favorable weather conditions, American farmers may be expected, in the absence of a restrictive program, to produce at times a quantity of agricultural products greater than the market can absorb at prices which will bring the producers adequate compensation. It is assumed, further, that extremely unfavorable weather conditions may occasionally produce serious crop shortages and excessively high prices. The plan for an "ever-normal granary," which is reflected in this Act, seeks to set up machinery to prevent the extreme price fluctuations which would follow unregulated production. In years in which the estimated total supply of a particular farm commodity exceeds a certain figure, marketing quotas are to be set if the approval of two-thirds of the producers is secured. Should these quotas alone not prevent the price from going below a designated figure, loans to producers will be made by the government, and the excess supplies stored. When climatic conditions result in a shortage, these stored reserves are to be released and placed on the market to prevent excessively high prices.

It is too soon to say how effectively this plan of price control will accomplish the end sought. If, however, it appears to represent a form of discriminatory protection to farmers against loss from price fluctuations, it should be remembered that the flexibility of particular prices varies considerably. Agricultural prices

are extremely flexible, while the prices of many of the commodities which the farmer must buy are relatively stable. Hence, the farmer is peculiarly susceptible to loss resulting from price changes. Moreover, it must also be remembered that the tariff represents a form of protection to industrial producers against at least one important possible source of price decline.

Conclusion.—The consequences of price level changes are sufficiently disturbing and far-reaching to warrant a thorough examination into the merits of any and all proposals that aim to control such fluctuations. In so far as psychological attitudes affect general price movements, no purely mechanical devices can be completely successful in providing a remedy. Moreover, the degree of knowledge and judgment that would be required for operating price control with complete effectiveness is probably not possessed by any individual, or by any agency which might be established. However, it has not been conclusively demonstrated that the errors which would be made in the application of price control measures would necessarily bring evils greater than those which are found in an automatic and freely fluctuating price system. Finally, it is necessary to have machinery for achieving stability in *both* the general price level and the prices of particular groups of commodities. This is essential if a satisfactory balance is to be attained. For, though a relatively stable general index might be maintained during a period in which agricultural prices were falling and industrial prices rising, stability of this kind would be of little advantage to the farmers. And if, on the other hand, agricultural legislation were carried to the point where farm prices were stabilized in the face of a falling general price level, wage earners would be bound to suffer. The entire problem of price stabilization cannot, then, be divorced from the broader questions of a balanced economy and general economic planning.

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1. What is meant by the price level?
2. What is a price index number?
3. What problems of selection are involved in the construction of an index number?
4. Why are many price indexes based upon wholesale commodity prices?
5. How do weighted and unweighted index numbers differ?
6. Construct (1) an unweighted and (2) a weighted index number.
7. Does a change in the price level mean a corresponding change in all prices? Explain.

8. What is the relationship between the index of prices and the index of purchasing power?
9. If the index of prices is 114, what is the index of purchasing power?
10. Distinguish between total national purchasing power and the purchasing power of the dollar.
11. State the equation of exchange, explaining each of the terms contained therein.
12. In what way might frequent and numerous industrial strikes affect the price level?
13. Do general price level fluctuations possess any particular characteristics? Explain.
14. How is the business enterpriser affected by price level changes? Explain.
15. Will the average individual's income, or his expenditures, fluctuate more nearly in accordance with the price level? Why?
16. What is the distinction between a wage earner and a salaried worker?
17. How are wage earners and salaried workers affected by price level changes? Explain fully.
18. How are creditors and debtors affected by price level changes? Explain fully.
19. Why might complete and permanent price level stability be undesirable?
20. Describe and criticize the "compensated dollar" plan.
21. What powers to influence the price level are provided in the Federal Reserve System?
22. Describe and criticize the multiple standard of deferred payments.
23. In what respect is the Farm Act of 1938 related to the question of price stability?
24. What is meant by the problem of "balance" in relation to price stability?

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10 BUSINESS CYCLES

IN THE PRECEDING CHAPTER, WE DISCUSSED THE CONSTRUCTION OF AN INDEX NUMBER OF THE GENERAL PRICE LEVEL, BASED UPON information regarding individual prices. In an essentially similar manner, it is possible to construct an index number of the volume of production, making use of production figures for particular commodities. When the statistician speaks of an index of production, he usually has in mind an index number that includes only agriculture, mining, and manufacture—that is, the creation of *form* utility. When production is thought of as embracing all phases of activities that increase utility, an index of production is commonly termed *an index of the volume of trade.* For example, the Federal Reserve Bank of New York prepares an index of trade which includes statistics on manufacture, construction, car loadings, imports, exports, wholesale and retail trade, electric power production, bank debits, security sales and issues, and so on. In such an index, attention is given to activities that represent the creation of time, place, possession, and service utilities as well as form utility.

The Nature of Business Fluctuations

Seasonal and Random Fluctuations.—Since any such index is representative merely of an average, there is no reason to suppose that there will be exact correspondence between the index of production in general and the index of production in any given industry. However, the general index will be affected somewhat by a change in any of the items upon which it is based. Just as there are seasonal price patterns for certain commodities, so also are there seasonal production patterns in certain industries. Seasonal peaks and troughs will not necessarily coincide as between industries, and will tend to offset one another to some extent. However, there is a degree of correspondence in individual seasonal production trends that is sufficiently pronounced to impart

a generally distinguishable seasonal pattern to the movement of production as a whole.

Production in various fields is also subject to the influence of such unpredictable events as wars, floods, droughts, strikes, and the like. The fluctuations resulting from occurrences of these kinds are irregular and are called, by the statistician, random fluctuations. Certain of these fortuitous developments may affect a large enough number of fields to produce a random fluctuation in the index of trade as a whole.

The Trend of Production.—Despite the frequency with which the volume of production varies in particular fields, it is usually possible to determine whether a given type of production is, on the whole, expanding or contracting. Automobile or radio production may vary from month to month, and even from year to year, but both industries have clearly been growing rapidly, if not uninterruptedly, since their inception. The manufacture of carriages and player pianos, on the other hand, has been steadily declining in recent years. The life of most industries is characterized by a gradual rise from a small beginning to a productive peak which may be maintained with little change for an indeterminate period, to be followed eventually by a gradual decline in the face of the introduction of new commodities.

The relatively steady, long-run movements that characterize this process are called the *trend.* Within any economic system will be found both expanding and contracting types of economic activity. Of course, one may offset the other, but it is more likely that there will be greater expansion than contraction, or vice versa, with the result that a definite long-run trend may be observable in the index of production or trade as a whole. Despite periodic setbacks, the economic system of the United States was unquestionably expanding—that is, exhibiting an upward trend—up to 1929. While our difficulties since that date have been of unusually long duration, there is as yet no conclusive evidence that the previous upward trend has been checked permanently. Of course, population growth or decline ordinarily plays an important part in determining the trend of production.

The Statistical Determination of Cyclical Fluctuations.—It is possible for the statistician to "adjust" his data. He may, for example, eliminate the seasonal influence, the effect of random fluctuations, or other sources of irregular fluctuations. The determination of the trend exhibited by his data becomes possible when

the effects of these other factors that might influence the situation have been eliminated. This trend can be carried back in time, making it possible to contrast the actual movements with the movements which would have taken place had there been no interference with the general tendency toward expansion or contraction. It is possible, likewise, to project this trend line a certain distance into the future. However, the extension of the trend curve into the past or future is always subject to inaccuracies.

Our primary concern, in the present chapter, is not with seasonal or random fluctuations, nor with the trend of economic activity, but rather with cyclical fluctuations. The latter are less regular than the seasonal, but more regular than the random fluctuations. Moreover, they may exert a simultaneous influence upon various forms of economic activity. What we have said thus far should serve to suggest methods of measuring the extent of cyclical fluctuations. In one method of measurement, the first step is the computation of the trend. The second is the elimination of seasonal and random elements from the data. Variations between the trend line, on the one hand, and the curve of the data corrected for seasonal and random elements, on the other, represent cyclical fluctuations. In the construction of Fig. 2, a trend line was computed and regarded as representing "normal" conditions. The curve of business activity, corrected for seasonal and random variations, was then plotted above and below 100, indicating the extent to which it departed from the trend line.[1]

Fig. 2 shows that fluctuations in business activity have been frequent, and on many occasions have varied extensively from the "normal." The most pronounced and most prolonged departure from the normal, as is indicated clearly in the figure, occurred in the period from late 1929 to the present time.

Cyclical Regularity.—By the term "business cycle," the economist means the period between successive peaks of business activity, or (since a cycle, strictly speaking, has no beginning) the period between successive troughs. Attempts have sometimes been made to generalize as to the length of the cycle. However, it is becoming increasingly apparent that such generalizations attribute to cyclical fluctuations a greater degree of regularity than they in fact possess. So long as cyclical variations are to be distinguished from the purely seasonal, the cycle must be thought

[1] Adapted from a chart prepared for the Cleveland Trust Company, Cleveland, Ohio, by Colonel Leonard P. Ayres.

of as extending over a period of time longer than a single year (and ordinarily for two years or more), but little more than this can safely be said of the duration of business cycles.

Periods in the Cycle.—Our hesitancy to generalize as to the length of the cycle should not be regarded as an implication that business cycles are completely lacking in common characteristics. For example, every major cycle may be divided (somewhat arbitrarily, it is true) into four periods. These periods are, in the order of their occurrence, *prosperity, liquidation* (also called the period of *crisis* or *recession*), *depression,* and *recovery.* Each of

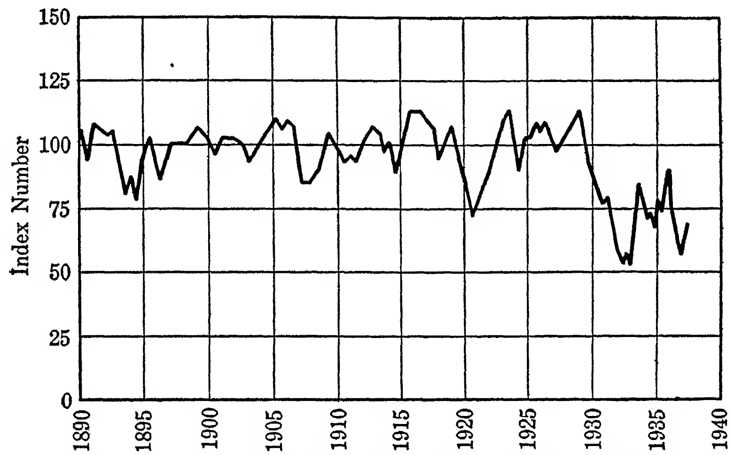

FIG. 2.—CYCLICAL FLUCTUATIONS IN BUSINESS ACTIVITY, 1890–JUNE, 1938.

these periods, moreover, appears to possess some similar characteristics in all major cycles. The period of prosperity is generally characterized by a large volume of production, which is selling at high prices. The creation of this large output requires a large volume of employment, which is paid for at relatively high money wage rates. The heavy demand for credit to finance the extensive business activity leads to large bank deposits, high interest rates, and low bank reserves.

Prosperity is followed by the period of liquidation. (We shall attempt presently to explain the causes of the transition from one phase of the cycle to another. At this point, we aim merely to describe briefly the nature of the individual phases.) The period of liquidation is marked by declining prices, lessened production,

increasing unemployment, and lower wages. On the financial side, bank deposits and interest rates are falling and bank reserves increasing. During the depression phase, prices, production, wages, employment, bank deposits, and interest rates are at a minimum. But all begin to rise in the period of recovery which follows. The cycle is completed when the recovery movement develops into a new period of prosperity, which will generally attain, in an expanding economy, a level of production higher than that reached by the preceding peak of prosperity. It should be added that what we have been describing is an "ideal," "normal," or "average" cycle, so that the description is not applicable to *every* business cycle.

Probable Causes of the Business Cycle

The Problem of Explaining the Cycle.—The frequency of occurrence and the general similarity of business cycles constitute the basis for believing that it may be possible to find a general explanation of the manner in which each peak of prosperity leads ultimately to crisis, and a new peak eventually begins to rise from the trough of depression. But it would be quite a different matter to secure general acceptance of any specific explanation. Business cycles cannot be studied in the laboratory, but must be observed in their particular historical context. Almost invariably there are certain random factors that are peculiar to any given historical period. Hence, it is easier to find an explanation for an individual business cycle in specific terms than in general terms.

The problem is further complicated by the common tendency to seek monistic interpretations and explanations of developments in any field of inquiry. As we have seen, the business cycle affects prices, production, finance, and, in short, most aspects of business activity. It would seem to follow that developments in any of these fields might in part explain the development of the cycle. Moreover, as will be stressed later, the psychological factor, as distinct from the economic, may play an important part in cyclical movements, and the political factor is assuming increasing importance. For these reasons, any monistic explanation must be suspect. Pluralistic explanations, on the other hand, run the risk of being so general in nature as to be either meaningless in terms of definite causal relationships, or incapable of being verified with accuracy, or both.

Factors Influencing the Cycle.—Business cycle theories have been developed, offering sun spots, weather cycles, the exploitation of wage earners, oversaving, underconsumption, discount rates, and optimistic and pessimistic error as explanations of these fluctuations in business activity. It is not possible for us to examine critically all of these many theories. And since any monistic theory would seem to constitute an oversimplification, it is probably best to restrict ourselves to certain factors which would seem to play a part in any satisfactory explanation. These include industrial, financial, and psychological conditions.

By industrial conditions, we mean levels of production, commodity prices, wages, profits, the volume of employment, and the degree of industrial unrest. Cyclical fluctuations are generally measured in terms of these conditions. The most important of the lot is probably the level of production, since the other conditions may be expected to vary primarily as a result of earlier changes in the volume of production. By financial conditions, we mean primarily the level of bank reserves and bank deposits, and the nature of the prevailing rate of interest. By psychological factors, we mean the degree of optimism or pessimism which exists among those who play an active rôle in the guidance and direction of production. It is unquestionably true that business cycles are not purely mechanistic in character. Business activity may expand in the face of structural weaknesses in the economic system, or decline to a low level in the face of external conditions that are apparently favorable for expansion. These conditions are the consequence of an undue optimism or pessimism which may characterize the attitude of the enterpriser and the capitalist.

Psychological Explanations.—In a sense, it would be difficult to exaggerate the importance of the psychological element. Recognition of this fact has led to attempts to explain the business cycle almost solely in terms of alternating periods of overoptimism and overpessimism. The former, it is said, leads to a too rapid expansion of production, which continues until doubt arises as to the possibility of continued expansion. This doubt spreads, a wave of pessimism grips the business community, a crisis occurs, liquidation and extreme contraction follow and continue until the almost total depletion of existing stocks gives rise to a new era of optimism.

But do not such theories overlook the fact that psychological attitudes are unlikely to change without some reference to external

conditions? It would seem that the psychology of the business enterpriser must have some basis in past or present economic conditions. It is more reasonable to suppose that changes in such objective conditions create psychological reactions, than that the psychological state is the prime mover. The principal importance of the psychological factor, therefore, appears to lie in the part it plays in accentuating, or prolonging, the periods of the cycle, and not in providing an explanation of the original cause of the transition from one stage of the cycle to another.

Much the same position must be taken with regard to the influence of such "external" conditions as wars, natural catastrophes, and the like. Their power to precipitate or prolong, to accentuate or diminish, a particular stage in any given business cycle is undeniable. Such random factors, however, can scarcely be regarded as furnishing a clue as to the general cause of so regularly recurrent a phenomenon as the business cycle.

A Pluralistic Explanation.—The crux of the problem is to determine the factor or factors which produce the transition from one period to another. This does not mean a mere enumeration of the consequences of such a change, once it has begun. Nor is it the same thing as listing the wide variety of developments which might affect the duration and extent of a movement in a given direction, once that movement is begun. To speak of the beginning of a cycle, however, is a contradiction in terms, for (as we have already suggested) a cycle, like a circle, obviously has neither beginning nor end, but is a continuous process. Therefore, we must break into the cycle at an arbitrary point, and seek to determine why the conditions then existing failed to continue indefinitely, and instead were transformed in such a way as to bring about a passage from one period of the cycle to the next. To attempt to work backwards is impossible, for in so doing we should inevitably be forced to make our way through an infinite number of earlier stages. We must start, therefore, at some arbitrarily selected point and work forward.

Admitting, then, that our selection of a particular point is arbitrary, let us break into a "normal" business cycle during the period of prosperity. We have already noted briefly the characteristics of this period. Prices are high and rising still higher. Our discussion of price levels, in the preceding chapter, showed that a period of rising prices is advantageous to the business enterpriser. Hence, enterprisers expand their output as rapidly as possible during this

period, in order to reap the full benefits of the rising price level. This expansion brings an abundance of employment and relatively high money wages. Increased production also increases the demand for credit, so that bank credits eventually expand to the limit, and interest rates are abnormally high. Because of the increase in the general price level and the large margin of profit enjoyed by producers, the prices of corporate securities show a steady increase. An increase in stock prices, if continued over a considerable period of time, leads to an increase in speculation and a corresponding increase in the demand for credit with which to finance this speculative activity.

Throughout this period, the desire of enterprisers to expand their productive capacity leads to an excess of investment over savings. Also, the increase in productive capacity takes place at a rate more rapid than the increase in consumption. This situation results from the previously noted tendency for wages and salaries to lag behind price movements. However, the optimism that prevails may be sufficiently strong to support continued advances, so long as resources and credit for further expansion are available. But once the available resources and credit are exhausted, the situation becomes extremely precarious. It is highly probable that, in certain lines, production has so far outstripped demand that large stocks have been accumulated, with the result that output must be curtailed, at least temporarily. Such curtailment stops or reduces the purchase of raw materials, decreases employment, and consequently reduces purchasing power.

The reduction in purchasing power lessens the ability of consumption to keep pace with production in general. Hence, contraction spreads to other fields, and each successive contraction still further reduces purchasing power and forces additional curtailment in production. In the face of such developments, bankers naturally become apprehensive about their extremely low reserves and begin to call in loans. Producers, having borrowed to buy new plant, the output of which faces a steadily contracting market, find difficulty in meeting their obligations. Loans to speculators are also called by the banks. Cash to meet obligations can frequently be secured only by the sale of securities. Such forced security sales depress the security market, already adversely influenced by unfavorable business conditions. Security prices may be forced down to such a point that their sale will not bring in an amount sufficient to meet loans that have been made on them.

In this way, too, the forced sale of industrial commodities to meet the demands of banks generates a precipitous and disastrous decline in commodity prices. Pessimism becomes widespread, banks refuse credit even on sound security, and business men decline to expand production even in certain fields where expansion might be feasible. The period of prosperity is now definitely at an end. The falling level of prices discourages production, and lessened production leads to further unemployment and consequent declines in purchasing power.

Eventually, forced liquidation comes to an end, and prices, having fallen precipitately, begin to stabilize at a low level. We have now passed through the period of crisis, and entered the period of depression. Here the volume of production is small, and unemployment is widespread. Conditions in general, however, show a relative stability. While pessimism continues, it represents primarily a fear to expand, rather than a fear of further contraction.

Despite the scarcity of purchasing power during a depression, an irreducible minimum of consumption, determined by the size of the population, is bound to take place. This minimum will, in many fields, exceed the depression level of production, and the result is a gradual reduction in existing stocks of goods. Eventually, production in these lines must be increased if only to satisfy depression demands. Increased production results in increased employment, and therefore in increased purchasing power. The rate of consumption is therefore raised, and further expansion of production follows as a consequence. As demand increases, prices begin to rise once more, creating a further condition favorable to business expansion. When these conditions become sufficiently strong to offset the pessimism that has prevailed throughout the depression, we are well into the period of recovery, which will eventually culminate in a new era of prosperity. But the latter will ultimately lead to a crisis, for reasons similar to those which caused the previous collapse.

We have here an explanation which is consistent with the fact that the cycle has neither beginning nor end. The theory avoids oversimplification by considering the influence of industrial, financial, and psychological factors. Avoiding reliance upon random factors, this explanation is not inconsistent with the degree of regularity exhibited by the cycle. Finally, by placing the source of each period of the cycle in the preceding period, it gives to

the cycle a self-perpetuating character which explains the regularity of its recurrence.

The Stabilization of Business Activity

Desirability of Stabilization.—Every period of depression means bankruptcies, unemployment, idle resources, want, and suffering. The desirability of introducing stability into economic activity, for the purpose of eliminating, or mitigating, the catastrophic consequences of recurrent depressions, would seem scarcely open to question. However, reliance upon pure automaticity, as opposed to conscious control, would necessitate the rejection of deliberate attempts at stabilization. It might be argued that the depression represents a painful but necessary period of cleansing for the economic system. Inefficient producers are driven out of business, and only the efficient survive. The expansion of production which ultimately follows the contraction of depression finds the productive agents reallocated, to a certain extent, in the interests of greater efficiency and of maximum ability to satisfy changed and changing demands.

Viewed in this sense, the business cycle insures the survival of the fittest, and, because it constitutes a threat to producers, it serves as an added incentive to maximum efficiency in production and the greatest possible effort to direct production so as to accord with the prevailing public desires. Finally, the believer in unadulterated automaticity may resort to the generalization that the cures attempted by any deliberate interference in the unhampered functioning of the economic mechanism will inevitably be worse than the disease which they seek to overcome. The implications inherent in such an attitude were noted in the preceding chapter. For the same reasons, we are again forced to reject this line of argument and to hold that any proposals which offer the possibility of achieving a greater degree of stability in our economic life merit our serious consideration.

The Significance of Proposals for Stabilization.—We have given some indication of the complexity of the business cycle. We were forced to reject monistic interpretations of the phenomenon. Consequently, there is no reason to believe that proposals dealing with isolated factors can eliminate the cyclical nature of economic activity. Considered separately, the most that can be expected of the proposals discussed below is a diminution in the frequency and severity of continuing fluctuations. Any considera-

ble degree of stability would probably require the simultaneous adoption of a number of devices. It should be clearly realized that no single measure, and possibly no combination of measures, is likely to provide a *complete* cure.

Cyclical Stability Through Price Stability.—The effect of rising price levels, in stimulating too rapid an expansion of production during periods of recovery and prosperity, has been mentioned. Conversely, in the period of liquidation falling prices force unduly rapid contraction. The way in which purchasing power may lag immediately preceding a crisis, because of the failure of wages and salaries to advance as rapidly as prices, has also been observed. It becomes apparent, then, that a plan of price stabilization might be used in an attempt to influence cyclical fluctuations. Hence, any of the proposals considered in the preceding chapter for stabilizing the general level of prices might be applicable also to the present problem.

There is no need to describe and analyze these proposals again. It would appear, however, that the most promising proposal for price stabilization is the intelligent use of the existing control over bank credit now intrusted to the Board of Governors of the Federal Reserve System. The potentialities of increased stability from this source are great. However, their successful application would require not only a high order of intelligence, but also the ability to resist public pressure. The achievement of stability would require the periodic use of measures for checking expansion. It is almost inevitable that both enterprisers and labor would vigorously resent and oppose governmental action that would be likely to limit the expansion of production and employment. If, however, control is to be effective, it must be applied before expansion has run its normal course and collapsed under its own weight. If the control of credit could be made to prevent undue expansion, the necessity for the liquidation and contraction which lead to depression would never arise.

Stability Through Public Works.—A second approach to the problem of stabilization centers around the maintenance of a reserve of public works projects. We have seen that, once the peak of prosperity has been reached, the initial steps in the direction of contraction lead to the creation of conditions which force further contraction. Specifically, contraction in even a single important field diminishes the available supply of purchasing power, and this decreases sales generally, and necessitates a reduction in produc-

tion in a variety of fields. It is argued that if the government were to keep in reserve a large-scale program of needed public works, and begin to put the program into operation as soon as contraction in private business took place, the decline in purchasing power would be prevented and the spiral of contraction halted.

It should be noted that we are dealing here with a plan which is not to go into effect until the peak of prosperity has been reached and passed. There is abundant reason to suppose that any such peak represents an abnormally high level of activity, which probably ought not to be maintained by artificial means, and certainly could not be permanently maintained except through huge governmental expenditures which would eventually threaten the credit standing of the government. The chief value of expenditures for public works in connection with the business cycle would seem to lie in the possibility that they might prevent a panic, and promote instead an orderly and gradual contraction. To attempt to prevent any recession whatsoever from the peak of prosperity would appear to be unwise. Hence, the proposal under consideration seems more likely to work out successfully in limiting the severity of cyclical fluctuations than in decreasing the frequency with which such fluctuations occur. It should be clear that the peak of prosperity would not reach such dizzy heights if, in "good times," the government collected revenue in excess of its current needs, thus reducing somewhat the purchasing power that would otherwise be available for private spending; nor would the trough of depression reach such profound depths if, in "bad times," these surplus funds were expended on public works.

Stability Through Unemployment Insurance.—Somewhat similar to the plan just described, because of its dependence on maintaining purchasing power, is the proposal to secure stability through the agency of unemployment insurance. The benefits paid to the unemployed from insurance funds would presumably take the place of the wages workers would be losing because of unemployment attributable to lessened production. Here, again, is an attempt merely to prevent the reaction from a business boom from becoming too serious; and the usefulness of this device would lie chiefly in its contribution to orderly contraction as an alternative to the panic of liquidation.

If we are to make expenditures for public works or pay insurance benefits to the unemployed, we must use care in selecting a sound method of raising the required funds. An unemployment

program that aims to prevent the spread of a business contraction which has already entered its initial stages, should not be financed by levying new taxes. For additional taxes would curtail private spending, and would merely change the direction of economic activity, and not increase its volume. Likewise, it would be futile to pay unemployment benefits from the receipts of current taxes. This financing should be done, rather, by public borrowing, on the theory that the situation is one of emergency, and for the reason that this borrowing will tend to increase the total volume of circulating media, and thus of purchasing power.

There is no good reason why unemployment premiums should not be collected in normal times, and the funds thus accumulated used to reduce the public debt, so that governmental credit and therefore borrowing power would be in excellent shape when emergency loans were necessary to provide funds for the payment of unemployment insurance benefits. Presumably, the financing of public works (advocated in the preceding section) would be done in essentially the same way—the public debt being reduced steadily with payments made from the surplus funds collected year by year, so that the government would be in a favorable borrowing position when it was necessary to build extensive public works in order to combat depression.

Stability Through Direct Action.—It will be seen that the plans discussed thus far suggest an approach to the problem of stability. They propose that we aid in promoting stability in production through such devices as the manipulation of money and credit, a public works program, and contributions to purchasing power in the form of unemployment benefits. The *direct* approach would involve the establishment of production quotas, and the direct control of output in the interests of stability. Under present conditions, we have no choice in this country as between the direct and the indirect approach. The former would mean the violation of the institutions of freedom of enterprise, freedom of competition, and private property, which many Americans prize highly. The direct approach could be used only by the exercise of a much larger degree of governmental control over business than now exists in the United States.

The utilization of the direct approach must await, therefore, our decision as a people to embark upon a planned economy under the guidance of the state, should such a decision ever be made. Whether such a transition is desirable is a debatable question. It

is highly probable that a fair degree of stability could be attained in a planned economy. But whether stabilization would take place at a level so low as to more than offset the advantages derived through the elimination of frequent fluctuations, is an open question. Moreover, we have in the past succeeded in maintaining a long-run *rising trend* of production, in spite of periodic fluctuations. It is possible that a rigidly controlled economy would tend to become static, substituting long-run stability for our present long-run expansion.

Among the characteristics of our present economic order are the following: A considerable degree of freedom of action for privately owned enterprises, with regard to price and production policies; rapid technological progress, resulting in frequent changes in the methods of production, and the continual development of new industries and disappearance of others; practically complete freedom of choice for consumers, with consequent frequent changes in the nature of demand; at least relatively free competition for the agents of production; and various legislative restrictions upon certain activities that are adjudged to be in restraint of competition. So long as these characteristics survive, it seems highly improbable that we shall succeed in eliminating the business cycle as a periodically recurrent phenomenon. But there is no need to accept the idea that we can do nothing either to mitigate the intensity and consequences of periodic contractions, or to check the unduly rapid expansion which seems to be the root of the difficulty. To adopt a defeatist attitude such as this would indicate an unwarranted lack of faith in human ability.

Reform, Relief, and Recovery.—Though an ounce of prevention is said to be worth a pound of cure, societies often manifest more interest in solving problems after they have arisen than in preventing their appearance in the first place. This is certainly true of the specific problem of the business cycle. The business community in general worries but little, during the upward swing of the cycle, about the possibility that expansion may eventually get out of hand. Most of our concern over business cycles is reserved for the period of depression.

The consequence is that we tend to confuse three separate and distinct classes of proposals. There are, first, the measures of reform. These are attempts to increase the degree of stability in economic activity, and include certain plans that we have already discussed. Second are proposals for relief. These represent efforts

to lessen the suffering and want that mark every period of economic stagnation. Third are devices aimed at bringing about recovery. Included in this class are all measures that are designed to increase economic activity. The measures directed toward bringing back recovery are temporary measures that have immediate objectives, and differ from the reform measures, which are permanent in nature and are aimed at long-run objectives. The situation is further complicated by the fact that there may be a considerable amount of overlapping among these three types of activities.

In the period which immediately preceded the crisis of 1929, little concern was manifested in fluctuations in economic activity. The era was characterized by an almost unprecedented optimism and a widespread belief that business depressions were phenomena of merely historical interest. But with the stock market crash of that year came disillusion. We have since had a striking example of simultaneous attempts at reform, relief, and recovery. This is particularly true of the period following 1933, for the federal administration in power prior to that date had based its policy on the assumption that the economic structure was fundamentally sound, and that little, if anything, in the way of reform was needed.

Governmental Attempts at Stability Since 1929.—It is well to note that, though political agencies in this country seldom hold the power to control economic activity directly, nevertheless it is to these agencies that we must turn for the initiation of any extensive measures that may be indicated for achieving either economic reform or business recovery. When faced with disequilibrium throughout the entire economic system, we cannot rely on the efforts of individual enterprisers to restore normal conditions. Action on an industry-wide basis, through trade associations or labor organizations, is only slightly less futile, (1) because of the high degree of interdependence between industries, and (2) because "cooperation" between business men is so likely to take the form of price-fixing through restriction of production.

Governmental attempts to remedy the situation that existed between 1930 and early 1933 consisted in large part of expressions of confidence in the fundamental soundness of our institutions and appeals to employers to maintain employment and wages. Regardless of whether our enterprisers saw the social desirability of following this advice, the situation was such that they could

not afford to do so in the absence of a governmental program directed toward insuring a general maintenance of purchasing power.

The Roosevelt Stabilization Program.—With the inauguration of the Roosevelt administration in 1933 came the beginning of the most vigorous program of reform, relief, and recovery with which the United States has ever undertaken to combat a business depression. We may outline this program briefly at this point, though many of its specific features are described elsewhere in this volume.

As we have said, it is often hard to distinguish clearly between relief and recovery measures. However, we may consider as predominantly "relief" measures, certain agencies that were established (1) to provide loans to distressed debtors and (2) to promote public works. Among the first was the Reconstruction Finance Corporation, established during the Hoover administration. Its task was to make loans (1) to banks that were fundamentally sound, but in temporary difficulties; (2) to the several states, for use in relieving unemployment; and (3) to corporations on the verge of bankruptcy. The Farm Loan Corporation was established to provide credit to farmers; and relief to home owners was extended through the Home Owners' Loan Corporation. These three agencies unquestionably aided in mitigating the suffering which inevitably accompanies a period of depression. They served the further desirable purpose of retarding the rate of liquidation.

The public works program inaugurated by the Roosevelt administration was unprecedented in its scope. Several billions of dollars were appropriated in each of a number of years, for carrying on this program of public construction. The desirability of planning public works in advance soon became apparent, for the program was slow in getting under way because adequate plans had not been prepared. Further delay was caused by a dispute over the relative merits of long-range planning and the building of works of lasting usefulness, as contrasted with engaging in a host of unrelated projects in which wages for labor would be the predominant cost. From the point of view of economy, the extensive adoption of the second of these policies was probably unfortunate.

While loans and expenditure for public works may halt a downward trend, action of a sterner character is required to promote

positive revival. Hence, the Roosevelt administration experimented with a variety of measures dealing with monetary matters. The general program has been termed "controlled inflation." The President was granted power to reduce the gold content of the dollar, to issue large additional quantities of "greenbacks," and to increase the quantity of silver in the monetary system. The object of these devices was, apparently, to raise the general level of prices, and this in turn was expected to lead to increased productive activity, for reasons which were discussed in the preceding chapter. However, this stimulus to price rise was offset, to some extent, by difficulties experienced in effecting an expansion in bank credit, over which the government had no direct control. These difficulties led to renewed demands, in certain quarters, that the government be given control over all agencies for the creation of credit. Whether this would or would not be desirable, it is certain that price control can be made genuinely effective only through the regulation of both money and credit, and not of money alone.

A further attempt to aid recovery took the form of trying to increase the incomes, and thereby the purchasing power, of wage earners and farmers. The National Industrial Recovery Act sought to increase wages and decrease unemployment by reducing the length of the working week. The cooperation of employers was secured by granting them, through the codes established under the Act, the right to impose limitations upon price competition, and in some cases upon the volume of production, within a given industry. The Agricultural Adjustment Act sought to increase farm incomes by raising the prices of agricultural products. This was to be done by reducing crop acreage. Both of these Acts are open to criticism, on the ground that they embodied a general policy of curtailed production. As a long-run objective, such curtailment has no economic justification. As an emergency measure, it seems a highly dubious method of getting back to either a high level of employment or a large volume of industrial production. Further, both measures revealed the difficulties of governmental efforts to influence economic activity, when the government has little or no power to control prices.

It is probable that the N.I.R.A. prevented wages from falling to as low a point as they would have reached had no such device been adopted. However, far from insuring against the possibility of prices increasing at a more rapid rate than wages, the Act prac-

tically invited such a wage lag. Hence, it contributed little to the real income of industrial workers. The restrictions on production embodied in many of the codes likewise offset the increase in employment which might otherwise have resulted from the undeniable reduction in hours. The increases in the level of industrial commodity prices also offset, to a considerable degree, the benefits of the increased money incomes that accrued to farmers through the operation of the A.A.A.

The Supreme Court ruled that both of these Acts were unconstitutional. However, in the field of agriculture, the Farm Act of 1938 provides an essentially similar farm measure. This Act is dealt with in our discussion of agriculture. The N.I.R.A. has not been replaced, but the Fair Labor Standards Act of 1938 provides for increases in the money incomes of industrial workers whose wages are strikingly low.

In the field of "reform," the Roosevelt administration adopted the following measures: (1) The passage of legislation increasing the powers of the Federal Reserve System; (2) the establishment of the Securities Exchange Commission; (3) the attempt to improve industrial relations as outlined in the Wagner Act; (4) the inauguration of a comprehensive program of social insurance. What will be the effects of these measures upon business stability in the future is a matter of speculation. It would appear that the possibilities of checking an undue expansion of business before it has attained dangerous proportions have been increased. It would also seem probable that the widespread payment of unemployment benefits would act as a brake upon the downward trend of purchasing power in periods of contraction. There is, however, no reason to believe that the problem of economic instability has been solved to any appreciable extent. It must be borne in mind that many governmental measures adopted in the post-1929 depression were designed to meet emergency conditions of that particular period of "hard times," and might not be applicable to another, and different, depression.

Conclusion.—In bringing our discussion to a close, certain questions of general significance may be raised. Is it true that the degree of economic stability attainable is in direct proportion to the economic control possessed by the government? If so, to what extent are we willing to sacrifice our present individual freedom of initiative in the interests of increased stability? To what extent can stability be achieved without acting as a deter-

rent to the normal tendency of our economic system to expand? It is with a recognition of the problems set forth and implied in these questions, that attempts to find a solution of the business cycle must be made. No phenomenon in the economic world has more serious consequences or presents greater difficulties than the one we have been examining. Indeed, the knowledge and understanding needed for an adequate solution of this problem are still largely lacking. For the present, at least, the problem must be approached experimentally, in the hope that we may come across clues which will lead us eventually to the development of a satisfactory solution.

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1. Distinguish between an index of production and an index of the volume of trade.
2. Distinguish between seasonal and random fluctuations in the volume of trade.
3. What is meant by the "trend" of production?
4. How can the extent of cyclical fluctuations in business activity be measured?
5. What are the four periods of the business cycle?
6. What are the characteristics of each period in the cycle?
7. What types of factors exert an influence upon the cycle?
8. What is the principal weakness of purely psychological explanations of the cycle?
9. What is the distinction between a monistic and a pluralistic explanation of the cycle?
10. Describe the conditions existing at the peak of prosperity.
11. Why is a period of prosperity inevitably followed by a crisis?
12. What conditions existing during the depression period give rise to a recovery movement?
13. What is meant by the "self-generating" character of the cycle?
14. What arguments might be advanced against the desirability of attempts to stabilize business activity? What merit do these arguments possess?
15. Why is it probable that no single device will succeed in achieving stability?
16. What relationship is there between price stability and cyclical stability?
17. What is the principal value of a public works program in connection with the cycle?
18. How might the payment of unemployment benefits influence cyclical movements?

19. How should the funds to finance a public works program during a period of liquidation or depression be raised? Why?
20. When and from what sources should the funds with which to pay unemployment benefits be secured? Why?
21. Is it possible to secure stability through the direct control of production? Why or why not?
22. What characteristics of our present economic system tend to make cyclical fluctuations almost inevitable?
23. Distinguish between reform, relief, and recovery.
24. Describe the governmental attempts at (1) relief, (2) recovery, and (3) reform, since 1929.
25. What additional governmental powers might have contributed to the success of the recent recovery efforts?
26. What is the relationship between governmental control over economic activity and the attainment of economic stability?

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PROBLEMS IN INTERNATIONAL ECONOMICS

11 THE TARIFF

INTERNATIONAL TRADE, CONTRARY TO THE OPINION OF MANY AMERICAN BUSINESS MEN, DOES NOT CONSIST OF "SELLING GOODS to foreigners." It means, rather, the exchange of commodities and services between people of different nations. An exchange of commodities and services, whether international or domestic, is, by implication at least, gainful to both the parties to the exchange. Where fraud and compulsion do not enter in, each party engaging in exchange maximizes utility by giving up something which he desires less for something he desires more.

A Background for Tariff Discussion

Trade and the Money Mechanism.—The fundamental nature of trade, both domestic and foreign, is obscured by the introduction of money and credit as media of exchange. Thus it appears that a man works at his occupation day after day, receives his remuneration in terms of the medium of exchange, and obtains through the use of this purchasing power the various commodities and services which he desires. What really happens is that he specializes in a certain task, produces a surplus of his product beyond his own needs, and exchanges this surplus for other goods which are turned out in a similar fashion by other specialists. Fundamentally, all trade is barter. In international trade, certain exporters sell goods abroad, and receive payment, by selling drafts, in the money of their own country. They themselves may never purchase or use an article imported from abroad. Other individuals, however, import goods from foreign lands and pay for them with drafts in terms of the foreign money. Importation and exportation appear to be separate processes, and many people do not suspect the close relation which exists between them.

If the medium of exchange is removed from the discussion of international trade, the true nature of the process becomes apparent. Commodities and services are exchanged for commodities and services. The purpose of exporting may be, for the individual

exporter, to sell goods for money. But, from the point of view of the nation as a whole, the purpose of exportation is to become able to import. In other words, it is to obtain certain commodities and services upon more favorable terms than are obtainable through home production. How, then, may a nation gain most by international trade? Will it be by giving to others many commodities and services, while obtaining few from them? Obviously not. We should seek, as a people, to obtain as many commodities and services as possible, while giving to others as few as possible. Why, then, do so many persons in this and other countries take pride and delight in a growth of exports, and view with such alarm any expansion of imports? In part, at least, the confusion arises from thinking of imports and exports as purchases and sales of goods for money.

Imports Must Equal Exports.—One important principle of international trade is that, over a period of time, the value of a country's imports must equal the value of its exports. A country cannot continue indefinitely to export more than it imports, or to import more than it exports. But the question at once arises, Why do we hear so much about the exports of the United States exceeding her imports, thus giving us what is called "a favorable balance of trade"? The answer is that in most popular discussions of international trade only commodities are considered and services are disregarded. It is quite possible for a country to sell more commodities than it buys year after year, but to call this a favorable balance of trade ordinarily means little. If both commodities and services are considered, there must come a time when imports will equal exports. It is not possible for a country continually to export more than it imports, because after it has been doing so for a certain period of time, forces are set in motion, familiar to every student of economic principles, which tend to reverse the situation. These forces are, under gold standard conditions, a flow of gold toward the country with the excess of exports, a rise in the general price level in that country, and a fall elsewhere. The former exporting country becomes a poor place in which to buy and a good place in which to sell, while the reverse is true of other countries, and the balance of trade changes.

The length of time necessary for this process to work itself out varies considerably from case to case. The gold which flows to the country that has an excess of exports may be kept from influencing prices through the action of the central banking system

of that country, or imports and exports may for a long time be kept in technical equilibrium by making loans which will cover the deficiency that would otherwise exist in the exports of other countries. In the long run, however, an export balance of trade will tend to be reversed.

If the trading countries are off the gold standard, the equilibrating forces are somewhat different. If, for example, the United States has an excess of exports to other countries, the rates of exchange on these countries will tend to be at a discount in the United States, because, in this country, many exporters will need to sell bills of exchange to the banks in order to collect payment for their exports, while but few importers will have to buy bills of exchange in order to pay for imports. As the banks' foreign balances become excessive, the rates of exchange will fall.

But the discount on foreign exchange in the United States will tend to check exports and stimulate imports. Our exporters will not be able to charge higher prices than before in foreign countries; and they will receive fewer dollars than before, when they convert these prices into American money, because of the discount at which foreign exchange is selling. Importers, on the other hand, can buy the foreign exchange they need more cheaply than formerly, and yet these foreign bills of exchange will go just as far as before in buying goods abroad. The result is that exports, which had exceeded imports, are reduced, and imports, which had been less than exports, are increased, with the net effect that by and by the excess of exports will disappear. A similar argument applies to a country which starts with an excess of imports.

The Gain from International Trade.—The purpose of international trade, from a national point of view, has been said to be the purchase of certain commodities and services upon more favorable terms than those on which they could be produced by the nation for itself. We of the United States, for example, obtain through international trade many products, such as rubber and silk, which we could produce for ourselves only with the greatest of difficulty, if at all. Here the gain from trade is clear, because other countries have an absolute advantage over the United States in the production of such articles. However, it is also advantageous for us to obtain from other countries certain products which could be produced in this country with equal or greater facility, in order to leave our land, labor, capital, and enterprisers free for

use in those lines of production in which our effectiveness or productivity is still greater.

A similar case may be found among individuals. A successful manufacturer may chance to be skilled as a mechanic. Perhaps he could repair his own automobile with a skill equal to, if not greater than, that of a garage mechanic. Would it pay him, then, to spend a portion of his time working on his car? Clearly not, for he will be sure to spend his time best in that occupation in which his advantage over other men is comparatively greatest. Similarly, on a larger scale, a nation benefits most by devoting its energies to those lines of production in which it has the greatest comparative advantage, or the least comparative disadvantage. This does not mean, as so many seem to believe, that each nation should produce only the one product in which its effectiveness is greatest. Many lines of production may well be followed in every country. Just where the line should be drawn between things that should be produced at home and those which should be imported is very difficult to say, but it is certain that in most countries, and particularly in the United States, many commodities are produced at home which could be imported to much greater advantage.

The Case for Free Trade.—The case for free trade is the case for the world-wide geographical specialization of labor. If every country specialized in those lines of production in which its effectiveness is greatest, the resources of the world as a whole would be used in the most productive way. The result would be the production of the greatest possible total of all commodities and services. When these economic goods were distributed on the basis of free trade, each nation would obtain a greater sum total of enjoyable goods than would be available through any other process.

The Prevalence of Restrictive Trade Policies.—While we should not rate highly the intelligence of an individual who tried to gain economically by giving away as much economic goods as possible in return for as little as possible, many nations have tried to gain by the adoption of a similar policy. That is, in spite of the weighty arguments for freedom of trade, most nations have adopted policies which greatly restrict the international exchange of goods. Various devices enter into the prosecution of such policies, but the most important is the protective tariff. Under a protective tariff, certain goods produced abroad are made dutiable at rates designed to exclude these products, thus leaving the

home market free for exploitation by domestic producers turning out the same kinds of goods. If, for example, a certain grade of cloth can be obtained from England for 25 cents a yard but cannot be produced in this country for less than 35 cents, then a duty of, say, 15 cents a yard is levied upon this grade of cloth, so that our wants must be satisfied by domestic manufacture, if satisfied at all. When similar duties of varying amounts are applied to hundreds or thousands of articles, the result is a "protective tariff." Many rates are more than sufficient to exclude the foreign products, while others are, in effect, low enough so that imports continue to come in to some extent despite the duties. But the purpose of the protective tariff is clearly the exclusion of foreign goods.

Particularly since the World War has it been true that large numbers of nations, whether or not they were formerly worshipers at the shrine of protection, have adopted protective tariffs. Moreover, practically all changes in tariffs until quite recent years have consisted of upward, rather than downward, revisions. The question which we consider in this chapter is whether it is wise for individual nations, and for the nations of the world collectively, to maintain such obstructions to trade. If protective tariffs are beneficial, it is highly desirable to discover how the disadvantages often associated with them may be reduced. And if in general they are detrimental, we should consider what steps may be taken to bring about their removal, or at least to revise them in a downward direction.

Protection as a World Policy.—Since territorial division of labor and freedom of trade would bring the greatest sum total of enjoyable commodities and services to the world as a whole, it is true that protective tariffs are a tremendous source of economic loss when considered from this point of view. They cause the resources of the various nations of the world to be used, in many instances, in lines of production to which they are ill adapted, and the gains which would result from the application of the principle of geographical division of labor are thus lost. The result is a much smaller total amount of goods for the world as a whole than the maximum which could be obtained. But the people of different nations do not often or seriously consider world advantages or disadvantages. Personal or local advantages are usually the prime considerations of immediate importance, while

national advantage is thought of as the ultimate goal to be attained.

The Protective Tariff as a National Policy

We now turn to an examination of the protective tariff as a policy for a single nation such, for example, as the United States. The controversy over the tariff has raged loud and long in this country. The arguments advanced in connection with it have run the gamut from abysmal ignorance and childish superstition to intelligent and clear-cut reasoning. There are Americans who are today no more advanced in their thinking on international trade than were many statesmen of the sixteenth and seventeenth centuries, and who believe that a protective tariff is a good thing because, by cutting down our imports, it enables us more easily to maintain a favorable balance of trade. Thus, they still hold to the ancient belief that a country, like an individual, may become rich by selling more than it buys. The meaninglessness of the central idea of this belief—the idea of a favorable balance of trade—has already been noted.

The Tariff as a Revenue Producer.—Others believe that a protective tariff should be maintained, without too much regard for its indirect effects, because the government could ill afford to do without the revenue which is produced by it. Such an argument mistakes the main purpose of a protective tariff, which is to exclude foreign goods from the domestic market. A perfectly effective protective tariff would not furnish a single penny of revenue to the government, because no goods would come in to pay the duties imposed. Only to the extent to which a protective tariff falls short of its prime objective does it add to our national revenues.

The Tariff and Industrial Progress.—Probably the most objectionable and completely fallacious argument for the protective tariff is that which often appears in newspaper editorials and in the speeches of politicians, to the effect that all the prosperity of the United States, past and present, is to be attributed to the policy of protection. When the protective tariff was first applied in this country, we were largely an agricultural nation, dependent upon European countries for most manufactured products. This, it is held, we would have remained if we had not adopted a protective tariff. Consequently, runs the argument, the credit for our

progress in manufacturing and our industrial development should be given to the tariff.

No one will deny that the industrial development of this country was hastened to some extent by our policy of protection. So many duties applied indiscriminately must certainly have afforded a stimulus for some industries. On the other hand, there is no doubt that our development has in other ways been retarded by the protective tariff. The principal objection to the argument is, however, that it disregards the tremendous natural resources of the United States and our growing population—in short, the presence in abundance of all the conditions which could not have failed to bring about the development of the United States into a great industrial nation under any international trade policy which might have been adopted. If the tariff alone were enough to cause prosperity and industrial development, there would be no excuse for any nation being poor and backward, because the application of the protective policy is relatively simple.

Official Opinions on the Tariff.—To show that fallacies concerning the protective tariff have been accepted in the high places of the land, it is only necessary to refer to a statement made by a former President, to the effect that the tariff cannot be a very great burden to American consumers because by far the greater part of our imports come into the country free of duty. Economists promptly replied that if the tariff rates were only made high enough, *all* our imports would come in free, since nothing would then be imported which was not on the free list. The duties actually paid are, of course, only a small part of the burden of the tariff. The greatest loss to consumers comes from their being compelled, because of duties sufficiently high to exclude foreign products, to buy many domestic products that are turned out at high cost because they are produced under disadvantageous conditions.

Then, too, there was the statement made by Senator Smoot, when he was sponsoring our unfortunate Tariff Act of 1930. He announced that, if the Act were passed, signs of business revival would be evident within a month, and that within a year we should have reached once more the high level of prosperity which was ours until 1929. Those who recall the harrowing years of 1931, 1932, and 1933, with their business stagnation and widespread suffering, can write their own comment on Senator Smoot's

judgment as to the stimulating effects of a high tariff upon business.

The Protection of "Infant Industries."—One of the earliest and strongest arguments for the protective tariff has to do with the encouragement of young industries. In so far as other countries have advantages over us in production which rest upon natural conditions, there is little that can be done about it. But, in the early days of a country, many advantages in production possessed by other countries are of the acquired sort; that is, the foreign industries are temporarily more productive because of the advantage of an early start and years of practice in these lines of production. To accept this condition as natural and permanent, and to buy the products of these industries from foreign countries continually, may be to disregard the young nation's best interests. For it may well be that, if the young and temporarily inefficient industries are protected from foreign competition for a time, they will develop in size and efficiency until their products can be turned out more advantageously than those of other countries. Clearly, a nation should produce goods at home whenever it is more advantageous to do so than to obtain them from other countries, and it is anticipated in the case of infant industries that the gains to be realized after the industries have grown up will be more than sufficient to compensate for the losses sustained while protection is necessary.

This argument is, therefore, valid to some extent, but its validity is weakened by two circumstances. In the first place, it is impossible to decide with accuracy in advance just which industries will eventually become strong and self-sustaining. The policy of the United States has been to grant protection whenever it was asked, and it is certain that some of the industries protected must have been greatly stimulated by our tariff. On the other hand, it is equally certain that some industries have been kept alive up to the present which should have been permitted to die a peaceful and natural death a hundred years ago. Such industries have always been dependent upon the tariff for their existence, and in all probability always will be. The second circumstance is that industries, however great and efficient they may become, never feel that they are sufficiently grown up to give up tariff protection and face foreign competition. The steel industry in the United States, for example, would be considered by most persons a particularly lusty infant, and yet it has not insisted that it be allowed

to make its way in the world without protection. Whatever may have been the validity of the infant industry argument in the past, it is certain that for the future it must carry very little weight.

The Home Market Argument.—Ignorance or disregard of the basic principles of international trade enables protectionists to advance what is called the "home market argument." It is contended that the exclusion of foreign products from the country will leave the home market entirely to domestic producers, thus giving them a new market in addition to that which they already enjoy. Production and employment will be stimulated, it is said, and wage conditions improved. But it is a fundamental principle of international trade that the exports of a country must equal the imports in value over a period of time, and that if a country will not import, it cannot continue to export. To the extent that the protective tariff shuts out imports, our exports must eventually suffer, and the home market is built up only at the expense of the foreign market. The home market may be slightly the more desirable of the two, or it may be less desirable. The question is not one to be decided in an off-hand manner. In any case, however, no large additional market can be created by the tariff.

Wages and the Tariff.—The most effective argument for protection, from the point of view of obtaining from the people of this country a sufficient number of votes to authorize the continuance of the policy, has to do with the effect of protection on wages. At times it has been held that the protective tariff is the cause of high wages. Does not the tariff permit the protected enterprisers to charge higher prices than they could otherwise charge, and do not the higher prices lead to higher wages for the workers? This line of reasoning puts the cart before the horse. According to the theory of opportunity costs, enterprisers in protected industries have to pay, for units of the factors of production, prices which are as high as these factors can command in other industries. The combination of the factors of production in the industries requiring protection, however, is for some reason not so effective as in other industries, so that the products of the former cannot be turned out at prices which will admit of effective competition with similar foreign-made products. As a result, these industries need a tariff because it will permit them to charge higher prices than could be obtained in competition with the industries of other countries, and it will enable them to continue producing while paying the current prices for the factors of

production. Since the market rate for labor is more than could be afforded in these industries if the tariff were not in effect, it is true in a sense that the protective tariff has the effect of bolstering up wages in these particular fields of business.

There is, however, no reason to suppose that higher wages will be paid for labor of a given grade in protected industries than elsewhere, or that wages in general will be raised by the tariff. The relatively high level of wages in this country depends upon the relatively high effectiveness, or productivity, of labor. Wherever the productivity of labor is high, wages tend to be high, regardless of the policy used in international trade. The United States glories in the possession of a comparatively high level of both money wages and real wages under a protective system, and yet England is ordinarily second only to us in both respects under a system which has been practically free trade. It would be most heartless of us to allow any of our people to live in misery and want because of insufficient earnings, if their condition could be improved by the simple expedient of enacting a higher protective tariff. That it could not be so improved reduces the high-wage argument to an absurdity. Our conclusion, then, must be that the most probable effect of the tariff on wages is to reduce real wages by causing the prices of many commodities to be higher than they would be without the tariff.

Protecting the American Standard of Living.—Many people in this country believe firmly that, while high wages are not caused by the protective tariff, the maintenance of a high level of wages and a good standard of living depends upon the tariff. The argument runs along these lines: The wages and the standard of living of workers in this country are high, and we take pride in the fact. But our enterprisers, because they pay high wages to these workers, necessarily have high costs of production and are therefore unable to compete under conditions of free trade with the enterprisers of other countries, who can secure their workers for much lower wages. Under the protective tariff, the cheap goods made by foreign "pauper laborers" are shut out, and our wages and standard of living can be maintained. If the barrier were once let down and a flood of cheap goods came into this country, our own enterprisers would be compelled to shut down and throw men out of work, or else keep their plants running by reducing wages to a point which would make the maintenance of the American standard of living impossible.

The flaw in this argument lies, of course, in the statement that high wages necessarily mean high costs of production. This statement seems unquestionably true to most persons who receive wages and to many others, and yet it is not necessarily true at all. No accurate estimate of labor cost can be made unless two facts are known: (1) The rate of wages paid, and (2) the amount of work turned out for the wages. High wages and large productivity of labor may very well mean low labor cost, while low wages and very low productivity of labor often result in a high labor cost. The truth of this statement can be established by reference to facts which are familiar to all. Money wages in the United States are the highest in the world. If high wages necessarily mean high costs of production, how does it happen that we can sell commodities to the value of billions of dollars a year ($5,241,000,000 worth in 1929) to the people of foreign countries? Why, with their low wage rates, can they not undersell us in everything? The answer is that our workers turn out so much product per unit of wages that costs are in reality low, not high, in these lines of production.

Does a country with a high wage level and standard of living have anything to fear from free trade with a country having a low wage level and standard of living? We think not. England with high wage rates and standard of living engaged in trade for many years on a basis of free trade with China, where these labor conditions are exactly reversed, but there was no noticeable tendency to drag English laborers down to Chinese wages and standard of living, or to raise Chinese laborers to the English level. It is important, then, to remember from this discussion that high wages and satisfactory living standards are dependent upon high effectiveness or productivity of labor, rather than upon the maintenance of a protective tariff.

The Tariff and Employment.—The contention that the protective tariff increases employment is related to the high-wage and home-market arguments. If we shut out foreign products, it will be necessary to produce our supplies of these goods in this country, and we shall have more industries than otherwise. These industries cannot run without laborers and there will be much additional employment created for our working men. This argument, of course, disregards the familiar fact that if we will not import, we cannot continue to export. As men are put to work producing the goods which are no longer purchased abroad, other

men are thrown out of employment in industries producing for the export market. The effect of the whole process is to shift large amounts of capital, labor, and land to the production of goods which could be obtained more advantageously from abroad, instead of using these factors in our export industries where they are especially productive. No large, additional source of employment is created by the tariff. We do, by erecting tariff barriers, make it more difficult for us to obtain the goods we desire, but that is a doubtful advantage. We could also "increase employment"—that is, provide more hours of work—if we impeded production by equipping our workers with ball-and-chain or handcuffs, but apparently our protectionists have overlooked the possibilities of this procedure.

The Protection of Vested Interests.—It is sometimes thought necessary to continue the policy of protection, once it is begun, even though some other policy would be more desirable if we were to begin over again. The reason given is that, under the guaranty of the tariff that foreign competition will be excluded, individuals have made large investments in protected industries and workers have adapted themselves to conditions in these lines of production. If protection is not continued, all of these individuals will suffer losses. It will be seen, however, that this is not an argument for the protective tariff, but, rather, one against the abrupt removal of protection. Economists generally would concede that the reductions in protection should come gradually, rather than suddenly, but that in any event reductions must be made.

The Tariff as an Instrument of National Preparedness.—When no other argument prevails, protectionists of the old school fall back upon the necessity for national preparedness. Under a system of free trade, the United States would be largely dependent upon other nations for certain commodities, and would be subject to the ever-present danger of having its supplies of these products cut off in time of war. Let us, then, maintain the protective tariff, and thus insure within this country the production of as many essential products as possible, say these protectionists. What if this policy does mean that, to a certain extent, our productive resources will be used ineffectively, and a smaller sum total of commodities and services than the maximum will be produced, just so long as our national security is promoted? This argument, of course, admits the direct uneconomic effects of protection and, in addition, falls short of the mark in another respect.

To try to become a self-sufficing nation is to follow a narrow nationalistic policy, and the instrument of this policy, the tariff, is a very prolific source of international ill feeling and friction. Though it may be admitted that it would be a serious matter if our supplies of important commodities were cut off in time of war, we may go still further and recognize the fact that when nations cooperate with and are dependent upon one another on the basis of freedom of trade, the likelihood of war is lessened to a marked degree.

Protection Against Dumping.—In recent years the protective tariff has come to be supported on grounds which appear to be quite different from those which are described above. The tariff is now advocated, for example, as a protection against the dumping of foreign goods in this country. "Dumping" is the term used when the practice is carried on by the people of other nations. When we ourselves engage in such practices, we regard them merely as good business. Dumping has been variously defined, but one useful definition describes it as the sale of goods at a lower price in one market than in another. If, for example, a French perfume sells at the equivalent of twenty dollars an ounce in France, and is marketed in the United States by its producer for ten dollars an ounce, dumping is taking place. Dumping is not a new source of worry for Americans. Indeed, our first tariff to contain any considerable element of protection was passed shortly after the War of 1812, largely because of the expressed determination of British producers to sell goods in this country for any price they would bring, or even to give them away if need be, in order to stifle the young industries which had sprung up in America and thus recapture our market for themselves.

The consideration of dumping gives us an interesting side light on the attitude of Americans toward foreign products. If the foreign products are offered at higher prices than those at which identical products could be turned out in this country, we are often inclined to purchase the articles from abroad as being of superior quality, or for some other reason. To offer us goods at the same prices for which they could be produced here is considered reprehensible, and our suspicions are at once aroused. If foreign producers plumb the depths of infamy by offering to furnish us certain products more cheaply than we could produce them ourselves, we begin to look for the "pauper laborer" in the woodpile and enact a tariff to protect ourselves from this threat to our economic wel-

fare. Finally, to include the worst possible case, if foreigners should offer to give us certain goods free of charge, we would probably go to the extreme of cutting off all trade relations with the offending countries.

Since everyone is presumably interested in getting as many commodities and services as possible at the smallest possible cost, why do we object to the sale of goods to us by the people of foreign countries at very low prices? It is because of the fear that this process will not be continued indefinitely. The sale of goods at these low prices might go on so long that we would become dependent upon others for them and give up their domestic production, only to find the prices raised later above the level at which the goods could be produced in this country. For this reason it is considered well to avoid goods which are offered on suspiciously favorable terms. It does seem, however, that dumping might be handled by special provision for the cases as they arise, rather than by continually maintaining high duties which permit the mulcting of domestic consumers.

The Tariff and Economic Stability.—The argument that the protective tariff may be of benefit because it promotes economic stability is close kin to the home market argument. It has been admitted that the tariff may be used to preserve the domestic market for American producers at the cost of reducing our foreign markets to a similar extent, but which market is the more advantageous appears to be a difficult question to settle. The economic stability argument holds that the domestic market is definitely more desirable, because it is more stable. "Let us produce and consume by ourselves to a large extent and shut out disturbing influences. The result may be, of course, that we shall have a smaller sum total of commodities and services to enjoy than otherwise, but may it not be better to have a smaller flow of goods, if the flow is more constant?"

Our answer to this question may well be favorable, as is anticipated by those who advance the argument, but it is at once necessary to ask whether economic stability can actually be obtained by this policy. To what extent is our economic instability the result of importing from and exporting to foreign countries, and thus likely to be affected by the tariff? It is extremely doubtful whether the major factors in the problem of economic instability will be much affected by the tariff policy. Even though foreign supplies of various products are excluded from the domestic

market, it will still be possible, unless domestic production is controlled, for our producers to turn out larger amounts than will be taken by consumers at prices sufficiently high to enable the producers to recover their costs of production. The demand for different goods will not be controlled by a protective tariff and can vary as in the past. Neither can the tariff prevent an overextension of credit in this country. It will consequently appear to most observers that there is room within a country such as the United States for a considerable degree of economic instability, even if outside influences could be shut out.

The Scientific Tariff.—Since the early years of the twentieth century there has been much talk about the "true principle of tariff-making," which is that the tariff rates should be just high enough to cover the difference between foreign and domestic costs of production. No favors or special privileges would be granted to domestic producers. Indeed, the tariff would be used only to guarantee a fair contest between foreign and domestic producers, according to its sponsors.

This principle, as it is ordinarily presented, sounds very fair and reasonable, but it will not bear close examination. In the first place, it would be difficult, if not impossible, to ascertain the domestic and foreign costs of production of a wide variety of articles. It is a sufficiently troublesome problem to obtain an approximation of domestic costs, and even greater difficulties are encountered abroad, where information of this sort is considered strictly private and is almost invariably withheld from investigators. Great expenditures would certainly be necessary to secure any worth-while information, and whatever data were obtained would probably be out of date before they could be used as the basis of tariff legislation.

Moreover, even if the principle could be strictly followed, the result would be disheartening. Trade is beneficial because it enables us to obtain goods more cheaply than we could produce them for ourselves. The effect of a tariff in equalizing costs of production would be to remove and destroy all the advantage which exists for us in international trade. Therefore, such trade would be wiped out so far as the United States is concerned. Then, too, let us consider what would happen in this country. All commodities would be protected and all that were consumed by us would be produced here, whatever the cost might be. If the commodity in question were bananas, the procedure would

be to find out how much more it would cost to produce them here than in Central America, and then apply a tariff rate sufficiently high to equalize costs of production. The result, so far as most consumers were concerned, would be to raise their price to a prohibitive figure. If the goods in question were rubber, silk or coffee, the same procedure would be followed.

It might be argued that no one would favor carrying the principle to such extremes, but it is difficult to say just where it would stop. We have records of speeches by United States Senators in which they state that they would be willing to see duties of 300 or 400 per cent applied, if necessary, in order to accomplish the purpose of the tariff, and, if we are to go to that extent, why not to 700 or 800, or to 2000 or 3000 per cent? Moreover, one Senator has favored the draining of the Everglades of Florida so that certain semi-tropical products might be raised there. Thus it may be seen that the protection of the commodities mentioned in the preceding paragraph is quite within the range of possibility. All in all, the "true principle" of tariff-making is a ridiculous and worthless one.

Conclusion on the Tariff as a National Policy.—Although the argument in the present section has been conducted in terms of the United States, as being of greatest interest to American readers, the conclusions which have been reached will apply, changing as conditions change, to other countries as well. The benefits that have been claimed for the protective tariff have been seen to exist largely in the minds of those who find it desirable to support protectionism for some other reason than the reasons they advance. Where benefits have resulted, it is usually true either that they do not continue into the present, or that they could have been obtained more economically by some other method.

The losses under protection are beyond question. The productive resources of each country are diverted from industries in which they would be especially productive to other lines in which their employment is relatively ineffective. The desired commodities and services are obtained under difficulties, and the sum total of goods available for the enjoyment of the people of the country is smaller than otherwise. This ill treatment of all the citizens as consumers results in gains for some enterprisers, but not for others. If the higher prices that can be charged under the protective tariff are just sufficient to enable producers to continue

in business in these ineffective industries, then (under conditions of competition) each factor of production will receive payment at the going rate and no more, and the loss to many persons in terms of higher prices will not be compensated by the gains to others. In other cases the tariff will allow prices to be sufficiently high to permit profits, and sometimes very large profits, to the owners of the protected businesses. It is axiomatic, however, that they never gain so much in profits as the people on the whole lose as consumers. In any event, this is taxation or exploitation of the many for the benefit of the few. Whether or not some individuals profit from the use of the protective tariff, it is to be condemned severely on economic grounds.

The Present Tariff Position of the United States

We now turn to a consideration of the present international economic position of the United States in relation to her tariff policy. Although this country has always been more or less definitely committed to a protective policy, it is particularly since the Civil War that she has been the acknowledged leader of the movement toward increasing protection. It is often contended by the supporters of protection that our constantly increasing tariff duties have not affected our trade adversely, since each increase in the tariff in the past has been followed by an expansion of trade. This contention is as difficult to disprove as it is to prove, because no one can say definitely how extensive the trade would have been in the absence of our policy of restriction; but there are strong reasons for believing that the tariff is a decided detriment to us now, in view of our present economic position.

The United States as a Creditor Nation.—In the middle of the last century, the United States was experiencing what has been called an "unfavorable balance of trade," that is, there was an excess of merchandise imports over exports. This meant nothing more serious, however, than that this country was a borrowing or debtor nation at the time. So long as we continued in that rôle there was little outspoken criticism of our tariff by other countries. People interested in collecting from debtors do not ordinarily discriminate against them or interfere with their chances of waxing prosperous and becoming able to pay their debts. Since the beginning of the last quarter of the nineteenth century, however, our trade balance and credit position have been changing. Especially during and just after the World War our loans to other

countries were tremendous, so that now the United States is in a commanding position as a creditor nation.

The Collection of International Debts and the Tariff.—At the close of 1930, the private investments of the United States in foreign lands were estimated at $14,900,000,000 to $15,400,000,000, and the discounted value of the debts of other nations to the government of the United States amounted to $7,000,000,000.[1] In June, 1937, the value of our private investments abroad was estimated at $13,210,000,000.[2] The debts of foreign governments to the government of the United States have at present only a hypothetical value, for payments by foreign nations to the United States on account of these debts have long since virtually ceased. Quite naturally, however, we do not wish to lose the value of our investments abroad or be unable to receive the income which they would normally produce.

Our loans and investments abroad were not made in the form of money. Instead they took the form of various kinds of economic goods. If the loans are to be repaid, if the value of our investments abroad is to be retrieved, and if we are to receive income from our loans and investments, payments will be made to us not in money, but in commodities and services. If other countries are to pay the United States, say, $300,000,000 in a given year, it will be necessary for their exports to exceed their imports by this amount. By the same token, we can receive such a payment only by allowing our imports to exceed our exports by the same amount.

In the face of the desire to collect our debts and the knowledge that the payments must be accepted by us in the only form in which they can be made (that is, commodities and services) we have twice since the World War raised our tariff wall against imports, and have thus made it increasingly difficult for other countries to send us goods. Our Tariff Act of 1922 gave us the highest level of tariff duties in the world, except for one other country, and decidedly the highest among the important industrial nations of the world.[3] The Tariff Act of 1930 was certainly

[1] United States Department of Commerce, "A New Estimate of American Investments Abroad," *Trade Information Bulletin No. 767,* Washington, Government Printing Office, 1931, p. 1.

[2] *Business Week,* October 23, 1937, p. 44.

[3] The League ofNations, Economic and Financial Section, International Economic Conference, *Tariff Level Indices,* Geneva, League of Nations, 1927, especially p. 16.

no improvement, for a study of comparative *ad valorem* rates in the two Acts based upon imports for consumption in 1928 shows an increase in the average rate of duty from 33.22 to 40 per cent, in so far as items were comparable in the two Acts.[4]

Our merchandise exports still exceed our merchandise imports by several hundred millions of dollars a year. Unless our imports can be increased, it will be necessary to reduce exports to an intolerable extent in order to bring about the excess of imports which is necessary to debt collection—unless our imports of service items from abroad should be susceptible of great increase. What, then, is to be done? Our desire to reduce, rather than increase, imports, as manifested in the Tariff Act of 1930, was a major factor in causing foreign nations to default on their war debt payments to the United States. It would be foolish to say that our restriction of imports was the only cause leading to these defaults, for the post-1929 depression and Germany's inability or unwillingness to continue her reparations payments to our debtors were also significant, as will be noted in the next chapter. But it is certain that we have made it very difficult for our debtors to continue their payments to us. If we insist upon maintaining exports while cutting imports to a minimum, it is probable that we shall have to consider present estimates of our loans and investments abroad as merely representative of the volume of such investments when and as made, rather than as amounts which we can hope to recover.

The Changing Nature of Our Exports.—Foreign countries have protested but little against our tariff policy until recent years, not only because the United States was a debtor nation, but also because our exports consisted predominantly of raw or semi-manufactured products which these countries greatly desired and against which they would not discriminate. Since the beginning of the last quarter of the nineteenth century, the trend in our exports has been away from raw and partly finished products toward manufactured goods. These are goods which can be obtained from others than us, or can be produced in the countries to which we export them at only slight differences in cost in many cases. Consequently, every upward revision of our tariff

[4] The United States Tariff Commission, *Comparison of Rates of Duty in the Tariff Act of 1930 and in the Tariff Act of 1922*, Washington, Government Printing Office, 1930, p. 1.

now brings in its wake a host of discriminations and retaliations against the United States.

Retaliatory Tariff Changes Abroad.—Of course, other countries do not ordinarily discriminate openly against the products of this country, or enact tariff laws which are avowedly retaliatory, because our President has been given rather wide powers in dealing with goods coming from countries which practice discrimination and retaliation. And yet it is not difficult to read between the lines of several foreign tariff changes which followed the passage of our Tariff Act of 1930. Let us consider, for example, the Canadian tariff law which came into being in the first half of 1931. This bill imposed new duties on 125 classes of goods, including textiles, shoes, paper, agricultural machinery, cast iron pipe, fertilizers, electrical apparatus, household equipment, gasoline, jewelry, and meats. Our modern protectionists claim that the bill was passed solely with reference to Canadian internal conditions, but the least trained eye can easily discover a preponderance of American products in this list.

As a second example, the most recent Spanish tariff act may be mentioned. In this act, duties were raised or new ones were imposed upon automobiles, razor blades, sewing machines, films, spun and artificial silk, and rubber tires and tubes. Again, it may well be suggested that, while the duties are applied to these goods from whatever source derived, the products listed are goods which are particularly likely to be coming into Spain from the United States.

The recent Czechoslovakian duty on automobiles is a neat example of a duty that discriminates, though it seems to be perfectly fair to all comers. The duty, as enacted in March, 1931, was a specific duty, that is, so much per pound was to be charged for each car imported. But the rate per pound was much higher for cars weighing over 2200 pounds than for those which fell short of that mark. Now it happened that the lightest of American cars, if we may disregard the Austin, was the Ford which weighed just over 2200 pounds, while most cars from France, the other chief source of supply, fell safely below this weight. Thus, while the duty applied to all countries, its effect was chiefly on us and our cars were, for all practical purposes, excluded. Can it be that the Czechs resented the duty which our 1930 tariff bill applied to boots and shoes, goods which formerly came in free of duty, and which in 1929 made up almost one-fourth of our imports from Czecho-

slovakia? It should be remembered that these are only a few examples selected from a long list of recent changes in foreign tariffs. If space permitted, they could be multiplied many times.

The Need for Action.—Regardless of who took the lead and who retaliated in the movement toward higher tariffs, the foreign trade of the United States, and of other countries, declined very sharply from 1929 to 1932 under the influence of the great depression, high tariffs and other restrictive policies In the year 1929, the United States had merchandise exports of $5,241,000,000, and merchandise imports of $4,400,000,000. By 1932, our merchandise exports had declined to $1,612,000,000, and our imports to $1,323,000,000. It is, of course, impossible to determine what part of this decline in our foreign trade was the result of our tariff and the tariffs of other nations, and what part was caused by the depression; but by 1935 our exports had increased to only $2,388,000,000 and our imports to $2,133,000,000, despite the recovery of domestic trade.[5]

Thus, our experience with the Tariff Act of 1930 merely served to emphasize an already apparent fact. In the interest both of advantage to the United States, and of peace and prosperity for the world as a whole, a moderation of the restrictions on trade, and especially a downward revision of tariffs, had become vitally necessary. However, there appeared to be little hope of bringing about a reform, either here or in other countries. To be sure, an occasional meeting of representatives of many nations was held under the auspices of the League of Nations to discuss, among other economic problems, the question of the tariff. But the representatives contented themselves with repeating well-worn platitudes about the desirability of free trade, while the countries which they represented went merrily on with their restrictive policies.

The Difficulty of Changing the Tariff.—Within the United States it has long appeared almost impossible to alter the prevailing sentiment which favors a high protective tariff. Many millions of our citizens are classed as wage earners, and these workers have been carefully "educated" in the matter of the tariff over a long period of time. That the protective tariff brings with it "high wages and full dinner pails" is to many workers

[5] United States Department of Commerce, *Trade Information Bulletin No. 833,* Washington, Government Printing Office, 1936, pp. 2, 83 In 1937, our merchandise exports were $3,345,000,000, and our merchandise imports $3,084,000,000.

much more than a mere political campaign myth. It is to them a tradition, a religion handed down from one generation to another, and does not appear to be open to argument. The responsibility for the development and maintenance of this belief is easy to place.

The Influence of the Press.—The tariff views of the workers as a class are largely the result of the news items and editorials of newspapers and the speeches of politicians. For many people the newspaper is the one and only form of literature, and certainly the only available printed medium of information on the tariff problem. Most of the newspapers with which one comes in contact, particularly those in the great industrial centers where large numbers of workers are found, have been staunch supporters of our tariff policy. To their editorial pages the worker, if his belief in the tariff has been shaken by hard times, may turn with every assurance of seeing repeated the familiar fallacies upon which was built his belief in the benefits of protection. Even in depression, he will find there assurances that the tariff was the foundation of our prosperity in the past and is our only hope for the future. Surely, those who depend upon the editorials of the average newspaper for an understanding of the principles of international trade must always remain in almost complete ignorance of the subject.

The Speeches of Politicians.—The speeches of men in political life, as heard directly or over the radio, or as reproduced in the newspapers, have also greatly influenced popular opinion on the tariff. For many years, both major political parties were in accord in favoring the protective tariff in principle, although they disagreed somewhat about particular schedules. Political talks on the tariff have been almost universally worded in terms of the ancient fallacies with which we are now familiar, and yet they have proved convincing to most wage earners and to many others. The candidate for public office says, "Vote for me. My party stands for the protective tariff, and the tariff is the cause of all your prosperity." People flock to his standard. If the same man said, "Vote for me, because my party stands for the protective tariff, and the tariff is the cause of the heavy rains which have brought you relief from the drought from which you have been suffering," these same people would laugh at him. And yet the tariff would ordinarily be as truly responsible in the one case as in the other.

Students often ask, Are our political figures, our Senators, and our Congressmen so ignorant of the principles of international trade that they really believe the arguments they advance about the tariff, or are these contentions made for a purpose? While many of the arguments are no doubt made in all sincerity, it seems very unlikely that all of our political leaders are really deceived by some of the absurd statements about the tariff, unless it is true that a man can repeat a thing so often that, despite its falsity, he eventually comes to believe it himself.

Senators and Representatives are elected from states and from districts within states. Since the interests of the people as consumers are rarely considered in Congress, the business of each member of that body with regard to the tariff is to get as many favors as possible for the business interests of his district. Some businesses within a district may be making large profits behind the tariff wall, others may be dependent upon the tariff for their very existence, and still others may not be concerned at all about it. In any case, the attempt is usually made to obtain protection for all. Many cases are on record of industries receiving a generous measure of protection where none was asked. Tariff advantages for one district can be obtained by members of Congress only by cooperating with other members desiring favors for their own districts. Whatever the method used, each member must look out for his own district, or powerful support will be withdrawn from him and at the next election he is likely to find himself one of the represented, instead of being himself a representative. Many tariff speeches are doubtless made as a justification of the actions of the members, and for popular consumption at home, to convince those who are not convinced and to reassure those who are.

The Attitude of Business Men.—The one discordant note in the hymn of praise for protection is the fact that many American business men are coming to view the tariff with doubt and fear. Of course, those whose businesses are dependent upon the tariff for large profits, or for their very existence, quite naturally continue to favor the policy of protection. Almost anyone in the same position would feel the same way. If a man knows that a certain policy is vital to his own interests, it is extremely easy for him to discover that this same policy is of the utmost importance for the welfare of the country as a whole.

On the other hand, the policy of protection is opposed by many

of our great bankers, who sense that restrictions on imports are great obstacles to a continuation of our foreign investment policy and to the development of New York City as an international financial center. Farmers, too, are coming to suspect more and more strongly that they have little to gain and much to lose from continued attempts to "protect" them. Finally, the owners and managers of industries which are efficient in their own right, which do not depend upon the tariff, and which are able to meet world competition, are beginning to oppose the protective tariff. Being able to meet competition, these industries are anxious to develop their exports further and gain the markets of the world, but they find themselves greatly hampered in their efforts because we have refused to accept imports freely and thus have made it difficult for the people of other countries to buy from us.

Our Present Tariff Policy.—While conditions did not appear particularly favorable for a revision of our tariff policy, despite business stagnation at home and the decline of our foreign trade, the Congress of the United States in 1934 enacted a law which may go far in modifying this policy. The Act, which was passed quietly, was called the Reciprocal Trade Agreements Act, and authorized the President to enter into reciprocal commercial agreements with other countries for the purpose of fostering international commerce. In such agreements, the President may modify existing import duties and other import restrictions in return for similar concessions from the other countries. He may not, however, increase or decrease any duty by more than 50 per cent, or transfer any article from the dutiable to the free list, or vice versa. The agreements can be consummated only after reasonable public notice has been given of the intent to negotiate with the other countries, after public hearings have been held at which those interested may express their opinions about the prospective agreements, and after seeking information and advice from the United States Tariff Commission, and the Departments of State, Agriculture, and Commerce.

The Original Canadian Trade Agreement.—Agreements with nineteen foreign nations have thus far been drawn up. These countries include Great Britain, Belgium, Sweden, Switzerland, Cuba, Canada, France, Czechoslovakia, and several South and Central American countries. Negotiations with still other countries are being carried on at present. While it is not feasible to consider

here all these agreements in detail, we may examine the provisions of a few of the more important ones.

Under the original trade agreement with Canada, which became effective on January 1, 1936, the United States granted tariff reductions, subject to quotas, on cattle, calves, dairy cows, cream, certified seed potatoes, lumber, and some kinds of timber. Duties were also reduced on hay, horses, live poultry, cheddar cheese, turnips, apples, maple sugar, halibut, patent and harness leather, ferromanganese, ferro-silicon, and acetic acid. The duty on four-year-old or older whiskies was reduced from $5 per gallon to $2.50. We guaranteed to maintain the present duty of 10 per cent on certain types of animal provender, and agreed to keep on the free list such articles as pulp wood, wood pulp, newsprint paper, shingles and laths, certain fishery products, certain furs, certain fertilizers, crude asbestos and crude artificial abrasives.

Canada, on the other hand, granted reduced duties on 180 commodities, and guaranteed us the lowest rates for any non-British country on 767 items and sub-items. Among the articles affected were fresh fruits and vegetables, wheat, machinery, industrial equipment, automobiles and parts, railroad cars and parts, electrical apparatus, iron and steel products, gasoline, lubricating oils, grease, cotton fabrics, and dressed furs. Potatoes, oranges (for part of the year), tractors, magazines, and periodicals were placed on the free list, and it was promised that cotton would be retained on the free list. Canada also promised to revise its system of arbitrary valuation of imports for tariff purposes, and to allow tourists returning to Canada from the United States to bring in $100 worth of merchandise per person free of duty.[6]

The French Agreement.—The trade agreement with France, signed in May, 1936, gives that country tariff rate reductions on 71 articles, including cigarette paper, brandy, champagne, vermouth, still wines, vanilla beans, lace, tinsel products, broad silks, perfumes and Roquefort cheese. France had no high duties on our products that she could lower, since she was accustomed to restrict imports through a quota system rather than by means of high tariffs. However, she lowered the already low duties on 19 American products, increased the quotas on 44 others, and guaranteed that existing duties on other products will not be raised.

[6] Details of the Canadian Agreement are taken from the *New York Times*, November 18, 1935.

American products affected by the agreement included fresh apples and pears, canned salmon, logs and lumber, silk hosiery, automobiles, tractors and agricultural machinery, radios and tubes, electrical refrigerators, typewriters, rice, tires and tubes, some other rubber goods, and some chemicals and textiles. France guaranteed that its tobacco monopoly would continue to purchase American leaf tobacco, and that the restrictions on the import of American moving picture films would not be increased.[7]

The Czechoslovakian Trade Agreement.—The trade agreement with Czechoslovakia, signed in 1938, was one of the most sweeping we have made, for it affected 76.7 per cent of our exports to that country and 55 per cent of her exports to the United States. One of the concessions most desired by Czechoslovakia related to her exports of shoes to this country. Czechoslovakian concessions to us included the reduction in duties on 7.8 per cent of our exports to that country, the assurance that duties would not be raised on 4.4 per cent of our exports, and a guaranty that 64.5 per cent of our exports would be retained on the free list.[8]

The 1938 British and Canadian Agreements.—In November, 1938, major trade agreements were concluded with Great Britain and Canada—the one with Canada supplanting the old agreement which had gone into effect in 1936. In the 1938 agreements, the United States received tariff cuts or other concessions from Canada with respect to 1489 products, and from Great Britain with respect to about 450 products. Canada and Great Britain received concessions from the United States on about 450 and 150 products, respectively. The agreements affect American exports valued at about $440,000,000 in 1937, and American imports amounting to some $260,000,000 in the same year.[9]

In signing its agreement with the United States, Great Britain acted for Newfoundland and about fifty non-self-governing colonies. The United States carries on about one-third of her total foreign trade with the areas included in these agreements, and the three countries together (the United States, Great Britain, and Canada) account for almost one-third of the world's total international trade. It is clear that the new agreements are of far-reaching importance. Indeed, the tariff agreement policy of the United

[7] *Philadelphia Evening Bulletin,* May 14, 1936.

[8] *Chicago Tribune,* March 7, 1938

[9] *New York Times,* November 18, 1938, and *Chicago Tribune,* November 17, 1938.

States could hardly have been judged successful until agreements with these countries were concluded.

Appraisal of the Reciprocal Trade Agreements.—It is impossible to determine the exact effects of the trade agreements upon the international trade of the United States. To do so would require a comparison of our actual volume of trade in recent years with the volume which would have been transacted in the absence of the trade agreements—and the latter, of course, is an unknown quantity. Our international trade is subject to so many influences that one cannot single out the specific effect of the trade agreements. Some people argue that our trade with all countries was probably affected in the same way by the general recovery of business in recent years, and insist that, if our trade has increased faster with the agreement than with the non-agreement countries, the influence of the agreements is indicated. However, this is not necessarily true. Our trade with Germany, for example, might be adversely affected by resentment felt here over that country's handling of the Jewish people, or her default on financial obligations; and trade with Japan might be similarly affected by our attitude toward her invasion of China, and her treatment of Americans in the war area. Since these are both non-agreement countries, a failure to consider these matters would result in giving our trade agreements with other countries more credit than they deserve. Having said this, we may note the fact that, as compared with 1935, our 1936 trade with non-agreement countries increased 9.2 per cent, while our trade with agreement countries increased 18.2 per cent.[10]

For the most part, the trade agreements have been favorably received in this country. The objections that have been raised have come more largely from small business men than from our major industries. Small business men, who have no hope of developing foreign markets, have been disturbed by the increased importation of foreign products. In addition, our tariff-minded politicians and newspaper writers have been making a determined effort to convince the farmers of the country that the present administration has "sold them down the river" in the matter of trade agreements.

The farmers are told, for example, that imports of cheddar cheese have increased fifteen-fold under the auspices of our trade agreement with Canada. The implication is, of course, that our

[10] *Foreign Affairs,* April, 1938, pp. 428, 429.

farmers have been badly injured by this development, but the tellers of the tale forget to add that, even after the increase mentioned, these imports amounted to only 2.2 per cent of the domestic production of cheddar cheese. Similarly, the farmers were urged to protest against increases in our imports of cream, which amounted, after the increase had taken place, to only one-tenth of 1 per cent of domestic production.[10] In the field of manufacture, it is customary for the same sort of person to bemoan prospective shoe imports from Czechoslovakia, which, under the recent agreement, may amount to 4,800,000 pairs, or 1¼ per cent of our domestic production.

However, our great industrialists apparently do not object to a little foreign competition at home, if they are permitted to regain the foreign outlets so essential to their economic well-being. The trade agreements are given the unconditional most-favored-nation interpretation. This means that, when we make a concession to one country, it will be granted to other countries as well, even though they do not have agreements with us. But it means also that a country that has a trade agreement with us cannot discriminate against our goods in favor of those of a competing country, without violating the agreement, and this is a matter of importance to our exporting industries.

In some of our major industries there is a growing recognition of the fact that protection of the domestic market is no great boon, so long as this home market remains depressed. One major factor contributing to depressed conditions in the domestic market has been the loss by our export industries of a large part of their foreign markets. When these industries are compelled to reduce output and lay off workers through such a loss, resulting from high tariff conditions, even those industries which are protected in their exploitation of the domestic market are bound to suffer from reduced purchases of their goods.

The leaders of these industries have finally come to realize, then, that any losses they may suffer because of increased imports will be more than balanced by an improvement in sales in the domestic market. For such improvements occur when our export industries are enabled to expand production, purchase raw materials in increased quantities, and reemploy labor under the concessions granted us by foreign countries by virtue of the trade agreements.

It is still too early to predict the final outcome of the trade

agreement movement. But it seems entirely possible that, if this movement continues and receives the support of the business men in our major industries, we may eventually adopt a genuinely reasonable policy with respect to international trade. And we may even see the day when employers and workers alike will decide that the story of the benefits of protection should be pulled down from the shelf of works on economics and placed among the fairy tales where, for the most part, it indubitably belongs.

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1. How would the absence of tariff restrictions tend to maximize the gain which the nations of the world could derive from international trade?
2. Would you favor the protective tariff from the point of view of the welfare of the world as a whole? Why?
3. Should we retain the protective tariff because of the revenue which it produces for the federal government?
4. Could we, by means of the tariff, monopolize the domestic market and maintain our export trade at the same time?
5. "The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A protecting duty, continued for a reasonable time, may permit the country which lacks this skill and experience to carry on the industry until the producers are educated up to the level of those with whom its processes are traditional." Comment on this argument for the protective tariff.
6. "We are importing at the rate of about $300,000,000 worth of foreign goods per month into the United States. Most of these goods could be made here. There is not a manufactured article produced in the United States in which the labor cost is less than 90 per cent of the total cost following the raw material from start to finish. Now, if that is true, of the $300,000,000 that we are sending abroad each month to buy foreign-made goods, $250,000,000 is going out from the people of the United States to employ German, French, English, Japanese, and Chinese labor, while our own workers walk the streets in idleness. Unless adequate protection is secured against foreign-made goods, there is little hope of this country being able to maintain the present standard of living of the American working man and woman."

   Is this a valid argument for the protective tariff? Why?
7. Is the protective tariff effective as an instrument for shielding a

country from outside economic influences and for promoting economic stability? Why?

8. Would the efforts of nations to be economically self-sufficient be more or less likely to promote world peace than would the economic cooperation and interdependence of these nations? Why?
9. What is meant by the "scientific tariff"? Explain. Would you favor a tariff law of this kind? Why?
10. Explain fully the disadvantages of the tariff policy of the United States, in view of the position of this country as a creditor nation.
11. Have other countries been indifferent to changes in American tariff laws in recent years? Explain.
12. Do you feel that our tariff policy should be affected by the fact that many of our exports are now manufactured goods?
13. Describe the change which took place in the foreign trade of the United States between 1929 and 1932.
14. Can this change be entirely attributed to our Tariff Act of 1930? Explain.
15. Explain fully why it has been so difficult in the past to obtain a downward revision of our tariff.
16. State the major provisions of the Reciprocal Trade Agreements Act of 1934.
17. Sketch briefly the nature of some of the most important trade agreements which have been drawn up under the Reciprocal Trade Agreements Act.
18. What is your opinion of the gains that might be realized under this Act? Explain.

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12 FOREIGN INVESTMENTS AND INTERNATIONAL INDEBTEDNESS

ONE OF THE MOST IMPORTANT ECONOMIC DEVELOPMENTS OF RECENT YEARS IS THE CHANGE THAT HAS TAKEN PLACE IN THE position of the United States from that of a great debtor nation to that of an outstanding creditor nation; for, throughout its history, up to the year 1916, the United States was a debtor nation. At the beginning of the World War, we, as public and private debtors, owed individuals of other countries approximately 5½ billion dollars, while foreign individuals and governments owed individuals in the United States about 2½ billion dollars [1] Between 1914 and the end of 1919, the United States made huge loans, both public and private, to many countries, and as a result found itself an international creditor to the extent of about 18 billion dollars. This sum, however, represented the nominal value of foreign obligations to this country rather than the actual value, which was probably about 14 billion dollars in view of the adjustments finally made in the war debt obligations of the Allied governments to this country. In addition, allowance should be made for our obligations to other countries, amounting roughly to 4 billion dollars; so that the net actual indebtedness of individuals and governments throughout the rest of the world to individuals in, and the government of, the United States at the close of 1919 was almost 10 billion dollars.[2]

The growth of the United States as an international creditor did not end in 1919, however. While our government ceased to lend to other governments a few years after the close of the war, the private investments of citizens in foreign securities and properties continued at a merry pace until, by the end of 1930, it was estimated that the total indebtedness of foreign individuals and governments to the United States government and individuals

[1] R. A. Young, *The International Financial Position of the United States*, New York, National Industrial Conference Board, Inc., 1929, p. 3

[2] *Ibid.*, pp. 48, 49.

in this country amounted roughly to 22 billion dollars.[3] This figure, however, did not include our investments in Alaska, Hawaii, and Puerto Rico, or in missionary and educational institutions abroad, or any *short-term* obligations due individuals in this country. If we deduct from this estimate some 4 billion dollars, as representing roughly our indebtedness to foreign countries in all but short-term obligations, there remained a net indebtedness to the United States of about 18 billion dollars.

Our Present Creditor Position.—Seven years later, in 1937, the international financial position of the United States was considerably altered. The estimate of 22 billion dollars, as representing the total indebtedness of foreign individuals and governments to this country in 1930, included 6½ to 7 billion dollars as the discounted value of the payments which other countries had agreed to make us in the future in settlement of the war debts. By 1937, the value of these war debt obligations, if they had any value at all, was problematical. Almost without exception, the debtor governments had made no payments on account of war debts since 1931, and were giving no signs of resuming payments. While, under certain conditions, the war loans might not turn out to be a total loss, it is certain that the real value of these obligations to us in 1937 was only a small part of their nominal value.

Direct and Portfolio Investments.—The private investments of American individuals and firms in foreign countries, which were estimated at from 15 to 15½ billion dollars in 1930, amounted to some 12½ billions by June, 1937.[4] Even this figure does not show the extent of the decline which had actually taken place in the value of our private investments abroad. These investments are divided into direct investments and portfolio (or security) investments. Direct investments are those which involve direct participation in commercial and industrial enterprises abroad, such as investments in American-controlled manufacturing and distributing organizations, mining properties, petroleum lands, plantations, and other properties. The portfolio investments include all our holdings of foreign securities, either publicly offered in this country or secured through purchase in the international market. The direct investments of about 7¾ billion dollars in 1937 represented the book value of these investments as reported by their

[3] United States Department of Commerce, Bureau of Foreign and Domestic Commerce, *A New Estimate of American Investments Abroad,* Washington, Government Printing Office, 1931, pp 1, 2.

[4] *Business Week,* October 23, 1937, p. 44.

owners at the close of 1929, with allowances for additions and deductions since that time, and the figure of 4¾ billion dollars for portfolio investments represented the par value of the securities.

While the estimate of direct investments allowed for changes in the quantity of these investments, it apparently did not allow for changes in their value, which must have declined appreciably from its 1929 level as a result of the depression. However, when the depreciated foreign values of these properties were converted into depreciated United States dollars, it is quite possible that the estimate given for these investments was about right. But this conclusion can scarcely apply to the portfolio investments. Since most of these securities were already expressed in terms of dollars, they could not benefit by conversion into devalued dollars; and the actual value of the securities was probably much less than their par value by 1937, because of total or partial defaults by the debtors on some three-fifths of the securities.

In addition to these two types of long-term investments, the United States had short-term investments abroad totaling some 700 million dollars, so that our total creditor position amounted to about 13 1/5 billions. On the other hand, foreign countries by 1937 had long-term investments in the United States to the extent of about 6¼ billion dollars, and short-term investments of about 2¼ billions, so that our net creditor position was less than 5 billion dollars, even if our foreign investments are taken at their nominal values.[5]

The Economic Effects of a Net Outflow or Inflow of Capital

The Meaning of an "Export of Capital."—In considering the process by which international indebtedness is incurred, we should recognize that, in speaking of international movements of capital, the word "capital" is being used in a somewhat different sense from that in which it is ordinarily used by economists. Its usual definition is "produced goods intended for further production"; that is, capital is a part of those scarce, material, and transferable goods that are commonly called "wealth." When borrowing takes place between nations, however, the capital that is imported and exported consists, in the first place at least, of purchasing power or claims upon wealth, rather than articles of wealth themselves.

[5] *Ibid.*, p. 44.

What happens whenever the individuals or governments of foreign nations obtain loans in the United States—or, to look at it from the other point of view, whenever we make investments in foreign securities or properties—is that purchasing power, such as bank deposits, formerly owned by citizens of this country is turned over to foreigners or foreign governments. A part of this purchasing power must be spent in the United States for the banking services in connection with the loan, while another part may be spent here if this country appears to be the most advantageous market for the particular commodities desired by the borrowers or if the terms of the loan provide that a certain part is to be spent here. It usually happens, however, that a considerable part of such loans is—for a time at least—wanted by the borrowers in some other form than commodities and services. Even though, in the last analysis, the borrowers in many cases will want commodities and services, their immediate desire is usually to obtain most of the loan in the currency of their own country, to be used there, or to obtain commodities and services from some country other than the one that extended the credit.

The borrowers' problem, then, becomes that of transferring purchasing power from the lending country to their own country. This may be accomplished by having their agent in the lending country use their credit balances to buy bills of exchange on the borrowing country and send them to the borrowers, or by themselves drawing bills of exchange against their balances in the lending country and selling the bills at home. Conceivably, their balances in the lending country could be used to buy gold there, which could then be transferred to the borrowers.

A Persistent Net Capital Outflow and the Foreign Exchange Market.—When a country has a persistent net outflow of capital, the problem of transferring the funds becomes serious. The borrowers' attempts to convert the funds by buying bills of exchange in the lending country add to the already existing demand for drafts on the borrowing country or on other countries not directly involved in the lending. On the other hand, their attempts to transfer funds by selling at home bills of exchange on the lending country add to the supply of such exchange already existing in the borrowing country. Since the increased demand in the lending country for exchange on

the borrowing country, and the increased supply in the borrowing country of exchange on the lending country, would persist because of the continuing loans, the effect would be to raise in the lending country the exchange rate on the borrowing country and lower in the borrowing country the exchange rate on the lending country. These changes in exchange rates seem likely to result ultimately in a flow of gold from the lending to the borrowing country, although other conditions may intervene to render this flow unnecessary during a greater or lesser period of time.

For example, it is probable that dealers in foreign exchange in the lending country can set up credit balances in the borrowing country through short-term advances by the banks there, and can sell additional exchange on the borrowing country by drawing bills against these balances. It is also entirely possible that the central bank of the borrowing country may intervene and offer to give the borrowers funds in the borrowing country in exchange for the claims against credit balances held by the borrowers in the lending country. The purpose in doing this, from the central bank's point of view, may be to prevent an inflow of gold when such a flow appears undesirable because of conditions either in the borrowing country or in the international credit situation, or to obtain foreign exchange which may be counted as a part of legal banking reserves in some countries. Either type of banking activity, however, will be indulged in only so long as it appears desirable with regard to banking, reserve, and gold conditions at home and abroad; and when these activities cease, a flow of gold tends to take place.

The Effect on International Trade.—If the flow of gold toward the borrowing country, because of a persistent capital movement, is so large and so long-continued that the lending country's credit base is reduced and the quantities of money and deposit currency in use are curtailed, there tends to be a decline in the general price level. On the other hand, the price level in the borrowing country tends to rise under the influence of the increases in money and deposit currency that have resulted from the borrowing process. In so far as the fall in prices in the lending country makes its goods appear cheap to other countries, it becomes a good place in which to buy and its exports become large in relation to its imports, since the commodities of other countries seem expensive as compared with the goods obtainable at low

prices at home. On the other hand, the borrowing country, with its high prices, becomes a highly desirable market, while it is able to sell only comparatively small quantities of its commodities and services in other countries As a result of this situation, the borrowing country comes to have an "unfavorable" balance of trade, while the lending country has an export surplus. ·

However, it is known that even substantial transfers of gold between countries do not necessarily alter their respective price levels. But whether the price levels change or not, the results may be much the same, for there is likely to be, in any case, an expansion of purchasing power in the borrowing country. The expansion may be extensive, since the country's banking reserves are increased by the inflow of gold, or by the acquisition of foreign exchange which is counted as reserves in some countries. The increase in the monetary demand for economic goods in the borrowing country is likely to stimulate production (and speculation), but a part of the purchasing power is likely to be used for importing products from other countries. Moreover, some part at least is likely to have the effect of increasing the exports of the lending country, either directly, or indirectly by way of another country or countries.

Qualifications and Conclusions.—This description of the effects of a persistent net outflow of capital from a particular country has been presented as simply as possible. Page after page of qualifications has been written on the theory described here. These qualifications concern such questions as the differences between domestic, import, and export prices when the general price level is rising or falling, the effects of lending upon countries not directly involved, and the influence upon trade relationships of such economic phenomena as dumping, international cartels, and tariffs and other obstacles to trade. The conclusion to be drawn from the discussion is that, when a country is experiencing a persistent net outflow of capital, its exports of commodities, services, and gold tend to be large as compared with its imports, while the reverse is true of the borrowing country. This import-export relationship in the lending country may come about through an increase in exports while imports are unchanged, by a decrease in imports while exports remain constant, or by a change in both. The same is true of the borrowing countries.

A Persistent Net Inflow of Payments on Account of Long-term Indebtedness.—International loans, however widely some

may appear to differ from others, are all alike in one respect, in that they make it necessary for payments to pass from the borrowing to the lending country on account of interest or dividends, and eventually in the repayment of principal. The longer a country has had a persistent net outflow of capital funds, the greater are the sums it must receive annually, and the more difficult will it be for the country to keep on lending enough to make the net flow of payments on the capital account move outward. Eventually the time comes when, from the standpoint of the lending country, the inward payments on account of existing indebtedness, added to the payments representing new investments of foreigners in the lending country, will exceed the exports of capital being made by the lending country, and the net balance of payments on account of long-term indebtedness will be inward, and not outward.

When this happens we may expect the same sequence of events as has already been described, except that the country which is being repaid will be in the position formerly occupied by the borrowing country. The need to transfer net payments to the former lending country operates to increase both the demand for foreign exchange in the repaying country and the supply of exchange on the repaying country in the one that is being repaid. The rate of exchange on the creditor country rises, while that on the debtor falls. Eventually, after the banks in each country have gone as far as appears wise in facilitating the transfer of funds, a flow of gold to the former lending country may be expected. Despite all steps that can be taken by the central banking system of the creditor country, some expansion of its purchasing power—that is, an expansion of its money and deposit currency as compared with that of the debtor country—may be expected. This relative change in purchasing power will, as before, influence imports and exports, tending, directly or indirectly, to increase imports to the former lending country and to increase exports from the debtor country, regardless of whether or not the price level rises in the creditor country and falls in the debtor country.

In ending this description, we may refer once more to the qualifications of this broad statement of theory which it might be desirable to present were this discussion more extended. Our conclusion is, nevertheless, that a country that is receiving a persistent net inflow of payments on account of long-term indebtedness will have an "unfavorable" balance of trade—that is, an excess

of imports in terms of commodities, services, and gold taken together—and that repaying countries will tend to be affected in the opposite manner. This changed relationship of imports to exports in the country that is being repaid may come about through a growth in imports while exports remain constant, through a decline in exports while imports remain constant, or through a change in both; and the same is true of the repaying country. It does not follow that the country that is being repaid will necessarily have an increase in imports from or a decrease in exports to the country that is repaying, or that the latter must have an increase in exports to or a decrease in imports from the country that is being repaid. These things may happen, or they may not. But we know that the country which is receiving net payments *must* have an import balance of trade in terms of gold, commodities, and services taken together, from whatever source derived, and that the reverse is true for the repaying country.

The War Debts

Now that we have examined the process by which a nation, or its citizens, makes foreign loans and investments, and the economic conditions which must be present if such debts are to be collected and loans repaid, we are ready to study the change of the United States from a debtor to a creditor nation. We shall consider the war debts first, since they were of great importance during the early years of the transition period. Moreover, we can scarcely understand the post-war private foreign loans and investments of the United States unless we have some knowledge of the war debts as a background. The war debts of our former Allies are, of course, a part of the long-term indebtedness of other nations to us, but they gave rise to so many perplexing questions that they warrant special treatment. And in this connection we must consider reparations payments from Germany to the Allied countries; for the two sets of obligations were closely related from an economic point of view, whatever may have been their legal relationship.

Experiences of the United States Before 1917.—Shortly after the World War began, the principal European nations found that their international trade relations had been greatly disturbed. Because they had to devote their own economic activities almost entirely to the conduct of the war, they could export very little to the rest of the world, while at the same time they found it neces-

sary to increase greatly the volume of their imports, chiefly from the United States. The heavy net balance of payments due us from the belligerent countries resulted in a marked depression of the foreign exchange rates for their currencies in terms of dollars; and, before long, it was necessary for them to borrow in the United States in order to pay their obligations to American exporters. Moreover, neutral countries came to depend upon the United States for commodities and credit, since their former European sources of supply were no longer available. Thus it happened that the movement of capital funds out of the United States during this period amounted to almost 5 billion dollars, most of which represented the purchase of new security issues of other countries and the repurchase of American securities that had been held abroad, although there were some few direct investments by American citizens in foreign properties.

The Creation of the War Debts.—After the United States entered the war in April, 1917, loans to the Allied countries consisted largely of direct advances from our government to their governments, as authorized by the various Liberty Loan Acts. It was these direct intergovernmental loans that resulted in the war debts. In making these loans, funds held by individuals and organizations in this country were turned over to the United States government through the purchase of Liberty Bonds. This government then placed the funds, or credits, at the disposal of the Allied powers as needed for the purchase of materials and supplies, the stabilization of foreign exchange rates, or for other purposes.

It may be asked how the United States could make these huge advances, totaling billions of dollars, to the governments of the Allied countries in so short a space of time. A large part of the answer, at least, lies in the fact that credit within the United States underwent a marked expansion during this period. The inauguration of the Federal Reserve System made possible a large expansion of credit through its low reserve requirements and rediscount provisions. Before we entered the war, much gold was shipped to this country by other nations, and this provided the legal basis upon which to build a large superstructure of credit. After we entered the war, the Federal Reserve Board followed a very liberal policy in making advances to the government and rediscounting commercial paper, and even made it possible to rediscount promissory notes secured by government bonds.

This expansion of bank credit served to increase the money

incomes of all classes of people, and made available for investment a great aggregate volume of savings, with which foreign securities and Liberty Bonds could be bought, and domestic securities could be repurchased from foreign holders. Thus, our government was given purchasing power which it subsequently turned over to the accounts of the borrowing governments. In terms of commodities, these savings and loans meant that, while our own physical production of goods was increasing to a marked degree, our citizens were economizing in their use of commodities and were thus making possible a surplus for export.

The war loans, which resulted in the war debts, differed from ordinary international loans in at least two important respects. As we have already noted, these loans were made by our government directly to the governments of the countries with which we were allied, whereas foreign loans are ordinarily made by individuals or companies in one country to individuals or companies in other countries. Hence, the war debts constituted a political, as well as an economic, problem in all the countries involved. In the second place, the proceeds of the war loans were used for purposes of destruction, so that their expenditure did not provide the means of repayment by adding to the productive capacity of the borrowers. Ordinary loans, of course, are made primarily for productive purposes. Since the war, the war debts have been so hedged about by considerations of a moral or ethical character that any attempt to consider them from a purely economic point of view would fail to take into account many important matters related to the question of repayment.

The Funding Agreements and War Debt Statistics.—Several years elapsed after the World War before arrangements were made for the repayment of the war loans. The first "funding" agreement, or arrangement for payment by installments over a long period of years, was concluded with Great Britain in 1923. Other funding agreements followed, until by 1927 the largest debtors of the United States had made arrangements to settle their war debts. The total nominal funded indebtedness of our debtors on account of war loans proper, purchases of surplus war supplies, purchases from the United States Grain Corporation, and relief credits, was 11,468 million dollars in November, 1928. To clear up this indebtedness, the debtor nations were obligated to pay some 20,938 million dollars, on account of principal and interest, between 1929 and the end of the debt-paying period,

about 1987. The value of these scheduled payments, as of 1929, was 7870 million dollars, with the future payments discounted at 4 per cent, or 6538 million dollars, if the rate of 5 per cent is used. Table 15 shows, as of 1929, the total funded indebtedness of some

TABLE 15.—THE DISCOUNTED VALUES OF THE WAR DEBTS OWING THE UNITED STATES GOVERNMENT RELATED TO THEIR NOMINAL VALUES[a]

Country	Total Nominal Funded Indebtedness, Nov., 1928 (in millions)	Total Remaining Payments Scheduled Under Funding Agreements (in millions)	Present Value of Scheduled Payments as of 1929 at 4% (in millions)	Present Value of Scheduled Payments as of 1929 at 5% (in millions)	Present Value at 4% as a Per Cent of Nominal Funded Debt	Present Value at 5% as a Per Cent of Nominal Funded Debt	Average Rate of Interest on the Debt as Funded
Great Britain	$ 4,480	$10,117	$4,132	$3,499	92.2%	78.1%	3.3%
France	3,933	6,663	2,393	1,958	60.8	49.8	1.6
Italy	2,027	2,332	657	509	32.4	25.1	0.4
Belgium	411	707	266	221	64.7	53.7	1.8
Others	617	1,119	422	351	68.4	56.9	
All Countries	$11,468	$20,938	$7,870	$6,538	68.6%	57.0%	

[a] Source: R. A. Young, *The International Financial Position of the United States*, pp. 192, 193.

of the largest war debtors, the total remaining payments under the funding agreements, the present values of the future payments, the present values as a percentage of the nominal debts as funded, and the average rates of interest charged. The discounted values of the future debt payments did not change greatly between 1929 and 1931, when all payments were discontinued.

The Reparations Settlement.—By "reparations" is meant ordinarily those payments which Germany was obligated to make to her opponents in the World War for the loss and damage to which the Allied and associated governments and their citizens were subjected by Germany. Some payments were to be made by other countries, but these were relatively unimportant. The first settlement of the reparations question in 1921 obligated Germany to pay a total of about 32 billion dollars, covered by "A" bonds of 3 billion dollars, "B" bonds of 9 billions, and "C" bonds of 20 billions. Of these, only the "A" and "B" bonds were really taken seriously by most observers. When Germany proved unable to continue payments under this plan, a new arrangement, the "Dawes Plan," was brought into operation in 1924. This plan called for annual payments of 596 million dollars by Germany, to continue indefinitely. Finally, in 1929, the "Young Plan" was

evolved, under which Germany was to pay annuities for 37 years, ranging from a low of about 401 million dollars in 1931 to a high of 578 millions in 1965. Thereafter she was to be liable for 22 further annual payments, averaging some 400 million dollars per year. Table 16 shows the total amounts to be received by the

TABLE 16—TOTAL REPARATIONS TO BE RECEIVED BY PRINCIPAL COUNTRIES, FROM GERMANY, 1929–1988[a]

Country	Total Reparations to Be Received (in millions)
France	$14,164
Great Britain	5,036
Italy	4,034
Belgium	1,361
All Others	2,515
Total	$27,110

[a] Source: D. P. Myers, *The Reparation Settlement, 1930*, p 59

various countries in reparations payments over the 59-year period. The discounted value of these reparations payments, as of 1930, was about 9 billion dollars, although the total payments to be made amounted to over 27 billion dollars.[6]

Could the United States Receive the War Debt Payments?—In connection with both war debts and reparations, we should bear in mind that the amount to be paid each year, rather than the total amount, is the most important consideration in attempting to pass upon the feasibility of payment and collection of these obligations. Table 17 shows the average annual amounts which were to be paid by the principal debtors to the United States on account of the war debts in the years 1930 to 1934, and the amounts to be received by these countries in reparations payments in the same years. There is good reason for presenting these figures together. While the United States consistently held that war debt payments were in no way connected with or dependent upon reparations payments, we knew in fact at a very early date that we were unlikely to collect the war debts unless the debtor countries received their reparations payments.

[6] The statistics on reparations are from D P Myers, *The Reparation Settlement, 1930*, New York, World Peace Foundation, 1930, pp. 57-59, and R. A. Young, *The International Financial Position of the United States*, pp. 182-185.

TABLE 17.—AVERAGE ANNUAL PAYMENTS TO BE MADE TO THE UNITED STATES BY DEBTOR GOVERNMENTS, AND AVERAGE ANNUAL REPARATIONS PAYMENTS TO BE RECEIVED BY THESE GOVERNMENTS, 1930–1934[a]

Country	Average Annual Payment to the United States on Account of War Debts (in millions)	Average Annual Receipt from Germany on Account of Reparations (in millions)
Great Britain	$170	$ 95
France	52	211
Italy	13	44
Belgium	8	24
All Others	13	45 (including payments to U. S.)
Total	$256	$419

[a] Sources: R A Young, *The International Financial Position of the United States*, p. 199; and D. P. Myers, *The Reparation Settlement, 1930*, p. 179.

Many people in this country have insisted that little difficulty would be experienced by the United States in receiving the annual war debt payments, because of their relatively small amounts. While 256 million dollars a year, the annual average payment due from 1930 to 1934, is a large absolute amount, it is only a fraction of 1 per cent of the annual income of this country in good years and bad, and not much above 6 per cent of our annual imports in ordinary times. But the war debt payments cannot be considered by themselves, for we would have to receive these payments in addition to all the other payments which must pass from other countries to this country year by year. Even in 1934, a relatively poor year, the interest payments due American holders of foreign securities were estimated at 215 million dollars, while earnings due us from the direct investments of this country abroad amounted to another (estimated) 200 million dollars in that year.[7] In good business years, both of these types of payments would be considerably larger. Finally, in an ordinary year, other payments must be made to Americans because of the repurchase, by foreigners, of their own securities owned by us, or their purchase of American securities, or direct foreign investments in the United States.

The Necessary Import Surplus.—It may be seen, then, that the total payments to be received from abroad on the long-term capital account in a given year might amount to a huge figure.

[7] *Barron's Financial Weekly*, September 16, 1935, pp. 5, 6.

These payments count as exports in our balance sheet of international payments. That is, they bring about a situation like that which results from a heavy exportation of a commodity (say, wheat), which would also require foreigners to make payments to this country. Therefore, if we are to receive these payments on account of foreign indebtedness, our total imports of commodities and services must exceed our other export items (which require payments to us) by the amount of the capital payments to be received. It would be necessary, in other words, for us to have a heavy surplus of imports, apart from the debt payments.

While under some conditions it might be possible for us to achieve this necessary import balance of trade, the fact remains that we have not done so in the past. Our high tariff has made it practically impossible for us to accept the necessary imports, and generally high tariffs throughout the world have made it difficult for the debtor countries to export enough to set up the necessary balances abroad, against which bills of exchange could be drawn to make the debt payments. It may also be noted here that the difficulty of making given annual debt payments is increased in depression years, when the total volume of international trade falls off, both for us and for other countries.

Past War Debt and Reparations Payments.—This general line of argument might be objected to on the ground that, in several years in the past, reparations and war debt payments have actually been made and received. But the explanation is that war debt and reparations payments have not been made and received in the past in any real sense. Between 1924 and 1930, Germany paid reparations to the amount of 10,300 million reichsmarks. In order to do this, we might assume on general principles that she had an export surplus of about the same amount, and thus acquired the necessary foreign balances against which the reparations payments were drawn. But, in fact, Germany had in this period an *import* trade balance amounting to 6,300 million reichsmarks. The large reparations payments were possible in the face of this import trade balance only because, in the same period, Germany had borrowed 18,000 million reichsmarks.[8] These loans came, to a considerable extent, from the United States.

Thus, through borrowing abroad, Germany acquired the foreign balances with which to make reparations payments to the Allies.

[8] *The Economist,* London, England, *Supplement on the War Debts,* November 12, 1932.

Similarly, when these balances came to the Allied nations, they were able to make war debt payments to the United States, despite their inability to export to us, and our inability or unwillingness to import from them, to any great extent. When the depression of 1929 came and Germany's foreign sources of credit dried up almost overnight, she was in a dire predicament, for her heavy borrowings obligated her to make large annual payments on her private foreign debts, in addition to reparations payments. Confronted by the depression and the high tariffs of other countries, Germany could not hope to expand her exports sufficiently to acquire foreign balances for purposes of debt payment; and, try as she might, she could not reduce her imports sufficiently to provide the necessary export balance of trade.

The Hoover Moratorium and After.—By 1931, it appeared likely that Germany, if left to her own devices, would have to default on her private debt payments to other countries, as well as on the reparations payments. This would have meant loss to many private investors in the United States, and, of course, the non-payment of war debts by our former Allies because of Germany's failure to pay reparations. Acting on the principle that half a loaf is better than no bread, President Hoover proposed that, for one year dating from June, 1931, all war debt and reparations payments should be suspended. The other nations concerned eventually agreed to this proposal. In this way, a default on private debt payments due American citizens was temporarily avoided.

In the summer of 1932, the Lausanne Agreement gave Germany permanent relief from her reparations obligations, although this abandonment of reparations was presumably contingent upon a like action by the United States with respect to war debts. Actually it meant the end of reparations despite the fact that this country took no action on the war debts. Nevertheless, Germany eventually defaulted on her private debt payments to other countries, by a series of gradual steps taken in 1933 and 1934. From the facts presented above, we arrive at the conclusion that we have been able, in the past, through a complicated and expensive process of transferring funds from one pocket to another, to pay ourselves the war debt payments. We have given no proof that we are willing and actually able to receive these payments from the debtor countries. Of course, since the Hoover moratorium, we have not had to face the problem of receiving war debt payments,

since the debtor countries, almost without exception, have shown no inclination to make the payments.

Even if the transfer of the annual war debt payments to the United States were accepted as feasible, the question remains as to whether it would be worth while for this country to receive them. An annual payment of 256 million dollars means to us only about $2 per capita, an amount which would have to be made up in taxes if the debts were not collected. However, the per capita importance of the payments would increase somewhat in later years. If the war debts are a factor making for political and economic instability in Europe, and an obstacle to the economic recovery of the debtor countries, then an annual sacrifice of $2 or $3 per capita by the people of the United States might turn out to be a very good investment in terms of our international trade relations with those countries. The discussion thus far seems to suggest that the war debt payments are of far greater importance to the debtor countries than to the United States, and it is to the investigation of this assumption that we now turn.

Can the Debtor Countries Pay?—Even if the debtor countries could export to a sufficient extent to acquire the foreign exchange balances essential to war debt payments, the governments of the debtor countries would have to collect the necessary sums from their citizens, presumably by taxation, before payments could be transferred to our government. In the case of the four largest debtors—England, France, Italy, and Belgium—it is true that the annual per capita payment on account of the war debts would be somewhat less than the $2 per capita it would mean to the people of the United States, but it would have to be collected under very different conditions. The per capita income of these countries is appreciably lower than that of the United States. England's per capita income may be two-thirds that of the United States in an ordinary year, but France's is very much less than our own, and Italy's much lower still. Moreover, in the debtor countries taxes absorb a much higher percentage of the national income than in the United States in ordinary years. Clearly, an annual per capita burden of a given amount has quite different implications under these widely varying conditions of income and taxation. But the fact that the creditor country is rich and the debtors are poor has no effect on the debtor's legal obligation to pay. The same conditions, in fact, often exist between individual debtors and creditors. On the other hand, there can be little doubt

that the conditions mentioned above are important in considering the likelihood of war debt payments.

Is There a Moral Obligation to Pay?—Whether the war debts are paid will depend for the most part upon the ability and willingness of the debtors to pay them. The debts are binding legal obligations, of course, but they are not enforceable. The United States would hardly care to go to war to collect payments of 200 to 400 million dollars per year. It is often said that the pride of the debtor nations in meeting their obligations and living up to their word will insure payment. It is true that a nation will often go to great lengths to keep from defaulting on an obligation which is thought to be just, but it is questionable whether its people will make similar sacrifices to meet an obligation which they consider unfair from an ethical or moral point of view.

From such a point of view, it is argued that our debtors are under no obligation to pay these debts to us. They were contracted after our entrance into the war—after the war had become our cause as much as that of our Allies. The advances should be regarded, it is urged, not as loans to countries pursuing an objective in which we took no interest, but as expenditures for the security and defense of the United States quite as much as for that of any of the Allied countries—in other words, they were contributions to a common cause. The United States entered the war in April, 1917, but at that time it had no troops that could be sent into the trenches. It was sixteen months before our army began to play an active part; but in the meantime, the troops of the Allies fought for themselves and for us, while we furnished supplies and money for ourselves and for them. It was a simple case of division of labor. Each country gave what it had. The only difference was that while the lives of those in the Allied armies who died for us were not expressed in the legal form of a loan, our advances of money and supplies to these countries were.

In addition, it is claimed that the language used by members of Congress in discussing the war-time advances to the Allies showed plainly that they were to be regarded as contributions rather than loans. One Senator said, "I am perfectly willing to give to any of the Allied nations the money which they need to carry on our war, for it is now our war. I would give it just as freely as I would vote to equip our army or maintain our navy." Said another, "We can [by the advances] effectively and in the immediate future, arm, strengthen and support those who are,

since our declaration of war, fighting our battles." Such utterances were many.

The arguments from an ethical or moral point of view have no legal standing whatsoever, for the war debts are valid legal obligations. They are definite and unequivocal, and were undertaken voluntarily by the Allied governments. They signed on the dotted line, and we have only held them to their word. The important thing at law is what is said *in* legislation, not what is said *about* it before it passes. These arguments are not presented as our own views. Nevertheless, we submit that considerations of this sort, if they exist in the minds of people in the debtor countries, will be an important factor in influencing them in deciding how far to go in making sacrifices in order that such debts may be paid.

Discrimination in the Debts Settlements.—Another point which has aroused considerable resentment in certain quarters is the discriminatory nature of the war debt settlements. In arranging these settlements, an attempt was made to observe the principle of ability to pay, but it now appears that the attempt was unsuccessful. Who, for example, would say that at present Great Britain is twice as able to pay interest on her war debt as France, or eight times as able as Italy? Yet the interest rates are in these proportions. Similarly, it seems most unfair that Italy should be required to pay only 25 per cent of her nominal debt, discounting the future payments at 5 per cent, while France was obligated to pay 50 per cent, Belgium 54 per cent, and Great Britain 78 per cent.

The Future of the War Debts.—In view of the facts that have been presented, it might seem that there is no hope that the war debts will ever be paid. Indeed, it is probably true that, so long as we maintained our traditional high tariff policy, the war debts were a hopeless proposition, and even our private loans and investments abroad were greatly endangered. However, since the signing of our recent trade agreement with France providing for mutual tariff concessions, there has been talk of a new agreement with respect to the French debt which will permit payments to be resumed. It may be that other countries will be willing to follow France's lead, if our tariff policy under the Reciprocal Trade Agreements Act of 1934 is continued. Any new agreements made with respect to the war debts will probably have to provide large further reductions in these obligations, in view of the fact that reparations payments by Germany to the Allies have been definitely canceled. It would be desirable, if possible, to convert

the war debts into private debts, in order to take them out of politics. This might be accomplished by allowing the debtor countries to float bond issues in the United States and use the proceeds to pay off our government once and for all. These bonds would be bought and owned by the citizens of this country and would thereafter form a part of the private foreign loans of the United States, being comparable to the many bond issues of foreign governments already owned by Americans. In any event, it is clear that our prospects of collecting at least a part of the war debts will be bright only if we follow fairly consistently a more liberal tariff policy than that of the past.

Private Foreign Loans and Investments of the United States

Increasing Private Indebtedness After 1919.—While the war loans made by the United States came to an end soon after the close of the war, the private foreign loans and investments of the United States continued to increase so that they approximately doubled between 1919 and 1930, reaching in this latter year a total of about 15½ billion dollars, as we have already seen. Many people regarded this increasing indebtedness to this country merely as evidence of a perfectly natural extension of our position as an international creditor brought about through loans of new capital to other nations. They have looked upon the pronounced surplus of merchandise exports which has been maintained by the United States in recent years, as the means by which the new loans were received by the borrowing countries. However, a careful study of the payments by and to this country on the long-term capital account in recent years leads to a quite different conclusion.

To determine whether there has been a net outflow of new capital from the United States to foreign nations in recent years, we must consider all of the several items that result in payments, on account of long-term indebtedness into or out of this country. Among the outgoing items there are payments on account of imports of securities (both new issues and those outstanding), investments of Americans in foreign properties, government advances to foreign governments, and redemption and sinking fund payments and interest and dividends on our securities held abroad. Among the incoming payments are included those on account of outstanding securities exported, investments of foreigners in properties in the United States, the principal of our government

advances and credits returned, interest and dividends on our private investments, interest on our government advances, and the redemption and sinking fund requirements of foreign securities held by us.

When the incoming annual payments are compared with the outgoing annual payments on the long-term capital account since 1919, a fairly good balance of the two movements of funds is observed. For a few years after 1919, there was a net outflow of payments from the United States, but somewhat later there developed a tendency for incoming payments to be slightly in excess of outgoing payments. This tendency has been accentuated since 1930, despite foreign defaults on securities and low earnings on our foreign direct investments, because of the almost complete cessation of new foreign loans and investments by citizens and companies of the United States. On the whole, then, there was no substantial net outflow of new capital between 1919 and 1930. Instead, we maintained and increased the net indebtedness of other nations to us by reinvesting the amounts due us on account of interest, dividends, and the repayment of principal. Individuals in the United States, of course, received such payments when due; but we as a people refused such payments, or at least canceled their effects, by making every year a net balance of new foreign investments and loans of substantially the same amount as we received on account of old loans and investments.

The Present Position of the United States.—As we have seen, the private foreign loans and investments of the United States amounted to about 12½ billion dollars in June, 1937. To get an idea of the geographical distribution of these long-term direct and portfolio investments, we shall go back a half-year to the end of 1936. Table 18 shows how our foreign investments were distributed at that time. We note that by far the greater part of our private foreign investments are in the western hemisphere. Canada is the most important single debtor country, our investments there being slightly larger than those in the whole of Europe, and considerably larger than those in South America. Germany is our largest debtor in Europe. It will be noted that in Canada and South America our direct investments exceed the portfolio investments, whereas in Europe the opposite is true.

As we stated earlier in the chapter, the United States in 1937 appeared to be a net creditor, in total loans and investments, to the extent of something less than 5 billion dollars. With respect to

TABLE 18.—THE GEOGRAPHICAL DISTRIBUTION OF THE PRIVATE LONG-TERM FOREIGN INVESTMENTS OF THE UNITED STATES AT THE CLOSE OF 1936[a]

Area	Direct Investments (in millions)	Portfolio Investments (in millions)	Total Investments (in millions)
Canada	$2,130	$1,634	$ 3,764
Europe	1,460	2,083	3,543
Central America and Mexico	855	42	897
South America	1,570	1,367	2,937
West Indies	975	132	1,107
Africa	130	2	132
Asia	435	385	820
Oceania	155	250	405
Total	$7,710	$5,895	$13,605
Add: Bank capital	125		125
Deduct: Estimated net repurchases by foreigners		1,100	1,100
Net Total	$7,835	$4,795	$12,630

[a] Source *Business Week*, October 23, 1937, p. 44.

long-term loans and investments, as distinguished from the temporary international movements of funds, our creditor balance was in the neighborhood of 6¼ billions. It should also be observed that the investments of foreign countries in the United States are very largely portfolio (security) investments, while those of the United States in foreign countries consist to a great extent of the relatively more permanent direct investments. Our creditor position is causing us little distress at present, because many of our foreign securities are in default and our direct investments in foreign lands are earning relatively little, while large quantities of foreign funds have been coming to this country because of war threats in other parts of the world. However, it seems likely that if conditions were normal the United States would find it necessary to receive net payments on the long-term capital account amounting to some 300 or 400 million dollars a year, even if present investments of foreign countries in the United States were maintained —and much larger sums if these investments were not maintained.

The Future of Our Present Investments.—The question now confronting us is whether our foreign trade will allow us to receive such large annual payments in ordinary years—and it

must be admitted that the future of this country as a creditor nation does not look particularly bright. We must remember that, even before the post-1929 depression, we were able to receive interest on foreign bonds and earnings on direct investments only because we were making new loans and investments every year to an amount which would approximately offset the necessary annual incoming payments. When the placing of new foreign loans and investments ended, with the coming of the post-1929 depression, our position as a creditor nation became critical.

The chief obstacle to our holding the rôle of creditor nation has been and still is our traditional high tariff policy. In order to send us the annual payments due us as a creditor nation, it is necessary for debtor countries to have adequate export trade balances and for the United States to have an adequate import trade balance—unless, indeed, we are to make large new investments abroad. It seems, therefore, that the private foreign loans and investments of the United States, as well as the war debts, are of very doubtful value unless we maintain a more moderate tariff policy in the future than in the past. If our tariff policy is moderated by trade agreements or otherwise, our direct investments may prove to be worth as much as they cost, while our portfolio investments may recover a large part, though scarcely all, of their original value.

But, it may be asked, cannot the United States achieve the import balance of trade essential to the payment of foreign debts without lowering the tariff and increasing the importation of dutiable articles? It is true, of course, that an import balance could be obtained by reducing exports, as well as by increasing imports, but it is difficult to believe that this alternative would be popular with the rank and file of American business men. If it were possible for our net imports of services to increase greatly, this country might receive large net payments on account of long-term indebtedness without much change in commodity imports. It does not appear, however, that any great or sudden expansion can be looked for. Certain "invisible items," such as tourists' expenditures, may be expected to increase as the years go by. Other items, such as the remittances of immigrants and payments for freight services, will probably remain fairly constant or decline, the first because of our immigration policy, and the second because of agitation for the development of an American merchant marine. All in all, no great amount of relief is to be expected from this quarter.

Non-dutiable Imports.—Finally, we must consider the possibility that a growth in imports from such countries and of such commodities as are not greatly affected by our tariff may take place to such an extent as to permit the receipts of large net payments on the long-term capital account. It will be remembered that the United States, in order to receive such payments, does not necessarily have to receive increased imports from the countries that must make payments to us. All that is necessary is that our imports of commodities and services from all sources taken together shall exceed our total exports by an amount sufficient to provide the means for receiving capital payments. Some increase in imports of the foodstuffs and raw materials that are on the free list and can come in without duty, may be looked for as the population of this country increases; but it seems very doubtful that it will be sufficient to bring about the necessary import balance of trade, especially since many of the industries using these materials may be facing a constant or declining volume of exports. We feel, therefore, that a moderation of our tariff policy is essential to the security of our present position as a creditor nation.

The Functions of Foreign Investments.—Since our present creditor position is somewhat unstable, it is important to determine what shall be our future policy with respect to a possible extension of our foreign credits. Despite our mistakes of the past, there are legitimate functions to be performed by foreign investments. They aid in developing new countries and backward areas. Thus they facilitate the extension of international specialization, or division of labor, and make for an increase in world production, markets, and trade. Foreign investments also contribute to the maintenance of an international financial system, based on the gold standard. They help to smooth out temporary disequilibriums of imports and exports, to distribute the world's gold supply among the nations, and to stabilize foreign exchange rates. They are, or might well be, a tie binding the nations of the world together.

Our past mistakes in making foreign loans and investments are fairly obvious. We have bought risky, high-interest foreign bonds from issuing governments already overburdened with public and private obligations to other countries. We have bought the bonds of countries which were notorious as graveyards for foreign investments, and as defaulters on their obligations. In short, we have loaned to foreign governments when we would never, as

private business men, have extended credit to prospective domestic borrowers under similar conditions. We have been willing to purchase the securities of foreign companies with high-sounding names without any real knowledge of their financial condition, present business, and future prospects. Undoubtedly, there is a certain glamour about a foreign investment, but glamour scarcely compensates the investor for the loss of principal or interest, or both. Even our direct investments abroad have sometimes indicated poor judgment, if nothing worse. However, these mistakes may be merely those of a country inexperienced in investments, and may conceivably be avoided when we are more experienced.

Our Future Policy.—Under certain conditions the present creditor position of the United States may turn out to be secure. Under certain conditions, again, an extension of our creditor position through new loans and investments might be economically wise and beneficial. One of the most important of these conditions, as we have said, is a modification of our tariff policy. To make large new loans and investments abroad, while maintaining our old high tariff policy, would be decidedly unwise. If we did this, the new loans and investments would for a time make it possible for this country to export heavily while importing lightly. Eventually, however, the annual payments to be received on account of old loans and investments would exceed, by a large sum, our new annual loans and investments, and the safety of our creditor position would be gravely endangered. Surely, in the light of our experience, we should realize that we must not extend our creditor position unless we are willing to accept the responsibilities of a mature creditor nation, which include the lowering of tariff duties and the acceptance of an import balance of trade.

Another essential condition, if we are to extend our creditor position, is an improvement in foreign investment judgment and standards. Our investors must learn that a poor investment is not sound merely because it is made outside the United States. They should understand that foreign investment is always risky, and in appraising prospective foreign investments should apply standards which are even more severe and rigid than those applied to domestic investments. Possibly our federal attempts to control the activities of investment bankers, as described in Chapter 6, will improve the quality of foreign securities offered to our investors. Investors in foreign securities and properties must also be given to understand that they invest at their own risk and that the

United States government in no sense guarantees the safety of these investments, or of those who administer them.

The extension of our creditor position should, and probably must, wait upon the settlement of the question of war debts. Finally, it must also wait upon the stabilization of monetary systems and of foreign exchange rates among the nations of the world. Foreign investment will probably remain at a standstill until prospective investors know, with a fair degree of certainty, at what rate the earnings of foreign properties can be converted into dollars, and what the dollars will be worth when they get them; and until they are assured, further, that some foreign dictator will not destroy the value of their investments by taking over the direct control of properties or forbidding the payment of interest on foreign-owned bonds. If we feel that internal economic conditions make it imperative for the United States to continue to use a managed currency, so that the dollar has no fixed value in terms of foreign currencies though it may have a stable purchasing power at home, the prospects of our making large new foreign investments will be anything but bright. And this decision would not necessarily be a bad one. If ever we must choose between the advancement of our domestic economic welfare and the growth of foreign economic relations, our choice must unhesitatingly be the first of these alternatives.

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1. In what respect did the international financial position of the United States change between 1914 and 1919? Between 1919 and 1930? Between 1930 and 1937? Explain.
2. Distinguish between direct and portfolio investments.
3. What is meant by an "export of capital"?
4. How does a persistent net outflow of capital affect the foreign exchange market? How does it affect international trade?
5. What conclusions can be drawn with regard to the economic effects of a persistent net inflow of payments on the long-term capital account?
6. Describe the creation of the World War debts.
7. In what respects do the war debts to the United States differ from other international indebtedness?
8. Describe the war debt funding agreements, and the various "settlements" of the reparations question which occurred prior to 1930.
9. Could the United States receive the annual war debt payments under a continuation of her past tariff policy? Explain.
10. How were war debt and reparations payments made prior to 1930? Explain.

11. How did the international financial crisis of 1931 come about? Explain.
12. Explain the nature of the Hoover moratorium of 1931, and the events which followed in connection with war debts and reparations.
13. Is the collection of the war debts economically important to the United States?
14. Can the debtor nations pay the war debts? Explain.
15. "Some of the most important influences affecting the willingness of the debtor countries to pay the war debts are considerations of an ethical or moral nature." Describe and evaluate these considerations.
16. How did our war debt funding agreements discriminate between the different debtor countries?
17. What is your conclusion with regard to our future prospects of collecting the war debts? Explain.
18. Explain carefully the significance of the private foreign loans and investments made by the United States between 1919 and 1930.
19. Why may the creditor position of the United States be described as "somewhat unstable" at present?
20. Under what conditions might our present foreign investments be both secure and economically beneficial?
21. What are the functions of foreign investments? Explain.
22. What grave mistakes have we made in the past in the field of foreign investments?
23. What should be our future policy with respect to extending our present creditor position? Why?

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13 THE ECONOMIC INTERDEPENDENCE OF NATIONS

MANY PUZZLING ECONOMIC PROBLEMS HAVE ARISEN FROM THE FACT THAT POPULATION TENDS TO EXPAND WHILE THE AMOUNT of land, including in this term all natural resources, is fixed. Well over a hundred years ago, when Thomas Robert Malthus was formulating his statement of the tendency of population to outrun the means of subsistence, it appeared that the population of Great Britain and other countries had nearly reached the maximum which could be supported. The present population of Great Britain, however, is about four times that which had appeared so large at the beginning of the nineteenth century, while the population of the world as a whole has approximately tripled in the same period of time.

Industrialization and Economic Interdependence

In fact, at the very time that Malthus was writing, a movement was under way which was to go far toward affording a solution for the difficulties which he saw and feared, although the solution brought with it new problems, among which is that discussed in the present chapter. The movement referred to was the speedy growth of industrialization, and its early events were so spectacular that it has long been called the Industrial Revolution.

The Case of England.—It is a well-known fact that a country of given size and given resources can support a much larger population through industrialization than it could maintain if its chief dependence were upon agriculture. England, for example, had great difficulty in providing food for her relatively small population a century or more ago. In recent years, however, she has been able to support a much larger population on a considerably higher standard of living. This has been accomplished by depending upon other parts of the world for from one-half to two-thirds of her foodstuffs, as well as for large quantities of other basic products, such as wool, cotton, copper, nitrates, zinc, and petroleum. At home the chief dependence of the country, outside of the mining

of coal, has been upon manufacturing. The manufacturing industries have provided enough goods to supply the domestic market and still leave a large surplus to be exported in payment for her heavy imports of raw materials and foodstuffs.

The Dependence of Italy upon Other Nations.—A similar development may be noted in other countries. Italy is a country of small area and poor soil, and is handicapped by an almost complete lack of important natural resources. Her population is large and the growth of numbers is encouraged by the government now in power. In spite of these limiting factors, Italy has achieved a moderate degree of industrialization in modern times. This has undoubtedly been the best way of caring for her population, but it has made her extremely dependent upon other countries in many respects. Until very recent years, considerable quantities of food have been imported, because even the most courageous efforts could not produce anything like an adequate food supply in Italy except at very high costs. It has also been necessary to bring in from other lands practically all of the raw materials for her industries, including cotton, wool, rubber, and most minerals. She is forced to import almost 90 per cent of the coal consumed in the country, while her sources of water power, though plentiful, are as yet largely undeveloped. Italy has had to sell many exports abroad to pay for the imports of foodstuffs and raw materials, and her position has been doubly unfortunate in that she has been dependent on other countries for many vital materials, while other countries were not similarly dependent on her.

German Industrialization and Dependence.—The industrialization of Germany has been a product of the years since the formation of the German Empire in 1871. Since that time Germany has experienced a growth of more than 50 per cent in population, the concentration of large masses of the people in urban districts, the development of a wide variety of manufacturing industries, a tremendous expansion in foreign trade, and the formation of many large business combinations, or cartels. It has become possible for the large present-day population of the country to enjoy a higher standard of living than that which prevailed in former years, but this economic progress has been obtained at a cost. That is, Germany has been dependent upon other countries for about a fifth of her food, including as much as a half of her total consumption of fats and, in addition, for large

quantities of raw materials, including rubber, materials for the textile industries, petroleum, copper, lead, and zinc. Since the World War deprived Germany temporarily of her principal deposits of iron, she imported a large amount of this mineral for some years, but her most important sources of iron ore have now been returned to her. It is true, of course, that in recent years both Germany and Italy, under the influence of a strong nationalistic policy, have been trying to achieve a high degree of economic self-sufficiency. Thus, they have tried to stimulate the home production of foodstuffs and raw materials, and to develop substitutes for materials which they lack entirely and cannot produce. However, such policies have obvious limitations, and these countries still remain dependent upon others to a considerable extent.

The Position of the United States.—Economic self-sufficiency is probably most nearly realized in the United States, and yet even this country is dependent upon others for a wide variety of essential products. As the industrialization of this country becomes more complete, the trend in our imports is more and more toward raw materials and foods and away from manufactured products, while the latter are an increasing part of our exports, replacing raw and semi-finished goods. The United States is completely dependent upon other parts of the world for supplies of sisal, jute, silk, rubber, tin, platinum, nickel, antimony, and asbestos, while our domestic production of tobacco, wool, manganese, chromite, vanadium, fluor spar, tungsten, magnesite, mica, quicksilver, graphite, monazite sand, and abrasives is insufficient to care for our needs and must be supplemented by importation.[1]

The Problem of Economic Interdependence.—As we have seen, it has been decided in many countries that the economic welfare of their large and growing populations could best be cared for by placing their chief economic reliance in manufacturing. This has made it necessary for these countries to look to other lands for large quantities of foodstuffs and raw materials for manufacturing, both because no country is suited for producing all essential materials for itself, and because in many of them the soil cannot be made to furnish sufficient food to provide for the needs of the very dense populations. At the same time, markets for large quantities of manufactured products must be found in

[1] W. S. Culbertson, "Raw Materials and Foodstuffs in the Commercial Policies of Nations," in *Annals of the American Academy of Political and Social Science,* March, 1924, pp. 12-20.

other countries, so that payments for the incoming foodstuffs and raw materials can be made.

Large-scale production has become the rule in the industrial countries and has made possible the realization of many economies. On the other hand, however, it has required large investments of capital and has brought heavy fixed costs, which make it imperative that the industries be operated continuously and as close to full capacity as possible. This, in turn, has made it necessary that the flow of raw materials be ample and constant, and that markets be ever available in which the products of industry can be sold. The dependence of the nations of the world upon each other for raw materials and markets, and their struggles to obtain and to retain control over these materials and markets, constitute the problem of the economic interdependence of nations.

The Quest for Colonies and Concessions

With several nations undergoing a process of rapid industrialization at one time and realizing more and more keenly the need for foreign markets and importations of raw materials and foods, it is not surprising that these countries cast many a covetous eye at the more backward areas of the world, which seemed capable of furnishing markets and materials, and possible homes for surplus populations. However, the needs of the industrial countries were so urgent that these nations declined to leave the development of backward areas to chance or to a competitive struggle between the rivals. Instead, each sought to reserve certain areas for its own exclusive colonial development. This does not mean that all colonies have been established because the mother countries needed foods, materials, markets, and relief from population pressure, for many other motives—sentimental, religious, and political—have led to colonization. It may safely be said, however, that these economic needs were a major factor in the struggle for colonies which marked the last few decades before the World War.

Results of the Search for Colonies.—As so often happens in economic and other contests, the most advantageous positions in the colonial field were taken by the early comers. The process of industrialization began first and developed most rapidly in England, and it forced an early recognition of the need for outside sources of food and raw materials, as well as for outlets for surplus population and manufactured products. The securing of colonies was considered to be the simplest means of satisfying

these wants, and through colonization the British Empire was made to grow by leaps and bounds. It is today, if considered as an economic unit, the most nearly self-sufficient political entity in the world. However, for certain purposes, the empire cannot be considered as a unit.

France also got an early start in the race for colonies, but she finished well behind the leader, England, in the quality and quantity of colonies that she finally controlled. Germany and Italy, who started late in the race for colonies, did not secure many rich colonial prizes. Both of these countries obtained colonies, largely in Africa, but they were for the most part areas which were not particularly desirable. Germany, of course, was stripped of her colonies following the World War.

The Economic Development of Colonies.—The degree of control exercised over the economic development of the colonies has varied greatly as among the mother countries. Some colonies have been left free to develop in their own way, while almost every phase of the economic life of others has been dictated by the nations in control. Quite often the mother country has definitely encouraged the production of essential foodstuffs and materials, or has discouraged the growth of industries which would compete with those already established at home. In any case, colonies have usually been furnished with capital for development through loans or direct investments, and have been aided in building transportation systems and securing credit facilities. The foreign trade of colonies is often controlled in the interests of the mother countries, which sometimes spend large sums to induce their citizens to emigrate to the colonies. Such inducements may include direct economic incentives to the emigrating people, free maintenance of law and order, and improvements designed to make life in the colonies attractive to prospective colonists.

Preferential Tariffs.—The methods by which nations attempt to reap the greatest possible economic benefits from their colonial possessions vary from case to case. One common method is the use of a preferential tariff system. Under such a system, lower duties are applied by the colony to products coming from the mother country than to identical products coming from other sources. Similar discriminations are made by the mother country in favor of the colony. Thus, the industries of the mother country are given the privilege of marketing their goods in the colony upon more favorable terms than those granted to producers in

other countries. Whether or not this is a great advantage will depend, however, upon the size of the preferential duties, which may still be sufficiently high to give protection to colonial industries.

While important raw materials are allowed considerable freedom of entrance by most industrial nations, it is often possible for a colony to derive much benefit from preferential duties applied to its products by the mother country. If, for example, the mother country is applying protective duties to certain foodstuffs and raw materials in order to stimulate domestic production, or if it levies high duties on certain foodstuffs for revenue purposes, preferential duties may be a distinct advantage for a colony. Preferential tariffs exist, or have existed, between Spain and her colonies, Portugal and her colonies, France and some of her colonies, and within the British Empire.[2]

Preferential duties, however, are not always on imports. Preferential export duties are often applied to raw materials, and are a menace to amicable trade relations between nations. The purpose of such duties may be in part to encourage shipping and trade, but it is primarily to stimulate industry in the mother country by furnishing it with raw materials upon favorable terms. A preferential export duty is simple in application. A certain amount is collected for each unit of the raw material exported, and a part or the whole of this amount is given back if the destination of the export is the mother country, or if it can be shown that the next process in the utilization of the material will be or has been performed in the mother country or another colony.

One example of a preferential export duty is that of India on untanned hides and skins. In 1919 an export duty of 15 per cent was applied to these articles, and a rebate of two-thirds of this amount was allowed on exports to be tanned within the British Empire.[3] This preferential duty affected American tanners adversely, aroused much resentment, and caused considerable trade to be diverted to other markets. The duty was changed in 1923 so that it affected all countries equally.

As has been said, preferential tariffs are often ineffective because even the preferential rates are so high that little advantage is given to the country that is nominally favored. To the extent that a real benefit is conferred, ill feeling and retaliation by other countries

[2] *Ibid.*, p. 46.
[3] *Ibid.*, p. 51.

are likely to result. The President of the United States, for example, has the power to impose additional duties on or even to exclude products coming from any country which discriminates against our commerce.

Assimilated Tariffs.—When the tariff policy of the mother country toward the colonies is that of assimilation, discrimination against other countries is complete, for under this policy the colonies are made a part of the mother country for tariff purposes. This means that colonial raw materials, which are subject to an export tax when shipped to other countries, pass to the mother country without interference. At the same time, both colonies and mother country may send goods to each other without fear of import duties, while goods from other countries attempting to enter either mother country or colonies run up against the tariff wall of the mother country, within which the colonies are included. The policy of assimilation has been applied by the United States to Puerto Rico, Hawaii and Alaska, and by France to many of her colonies.

Protectorates.—When industrial nations have deemed it impossible or unwise to secure complete control over a backward area through colonization, they have been able at times to accomplish some of their ends through the development of protectorates. A protectorate exists when one state, usually by treaty, gives to another and stronger state a considerable degree of control over its foreign relations, or possibly the right to intervene in its domestic affairs under certain conditions, in return for a guaranty of protection.[4] Protectorates have often been set up when an industrial nation has hesitated to take the military action necessary to bring a backward area under complete control or when an attempt at annexation might have aroused the opposition of other industrial powers. Protectorates have, in general, furnished a rather unstable type of control over backward areas, for they have usually become outright colonies in due time or have achieved their independence.

However, they have, in their time, given the protecting nations certain important advantages. The protected countries have often agreed not to conclude any treaties with other countries, obtain any loans from other countries, or make concessions to the citizens of other countries without the consent of the protecting countries.

[4] *Encyclopedia of the Social Sciences,* New York, The Macmillan Company, 1934, vol. 12, pp. 567-571.

The latter are often allowed to maintain troops in the protected areas, appoint governor-generals, and safeguard the personal and property rights of the citizens of the protected country who are located in other lands.

Mandates.—Some control over the development of backward areas is also enjoyed by certain nations under the so-called mandate system. This system developed after the World War, under the auspices of the League of Nations. Under a mandate, an advanced state holds a backward area in trust for the League of Nations, helping to administer its affairs until it is able to stand by itself. The mandatory state is expected to administer the controlled area for the benefit of the people of that area, and not for its own advantage, and to maintain the "open door" policy with respect to other nations. That is, other nations must be free to do business in the mandated territory, to make investments there, and to receive concessions for the development of resources. However, some advantages of an economic character are almost certain to be enjoyed by the mandatory nations from their control over backward areas.

Concessions.—Even in the absence of political control, it has often been possible for industrial nations to achieve a measure of control over backward areas by means of concessions. A concession is a grant of power, usually given by a country in which governmental control is weak and which is undeveloped economically, to individuals or companies of other countries to utilize mineral resources or otherwise develop an area, subject to certain rules and restrictions imposed by the granting country. Concessions may be granted for a variety of purposes, but the most important are probably plantation, mineral, and petroleum concessions.

While concessions are not usually made directly between nations, it is nevertheless true that national governments are greatly interested in concessions granted to their nationals. The struggle for the oil reserves of the world has been particularly keen since the importance of petroleum in the operation of warships and other ocean vessels, as well as in its many uses on land, has become apparent. Access to adequate oil resources now appears to be almost a matter of national life or death. Great Britain, besides being closely affiliated with the Royal Dutch-Shell oil interests and insisting that the Turkish Petroleum Company's

operations shall be British-controlled, owns a majority of the shares of the Anglo-Persian Oil Company.[5] This company has a blanket concession which gives it control, until 1961, over the oil resources in all of Persia except five northern provinces. It also owns in part the Burma Oil Company, which is prominent in the Burma field where the British have a monopoly. Concessions for the development of the oil resources of Mesopotamia have changed hands several times. These resources are now being exploited by a British-controlled company, though American and French oil companies are allowed to participate.

The Netherlands is directly interested in the Royal Dutch-Shell group, which has a practical monopoly of petroleum production in the fields of the Dutch East Indies, as well as important concessions in South and Central America. While the government of the United States is not so directly interested in American oil companies as are the governments of Great Britain and the Netherlands in their respective companies, it is nevertheless true that our government is much concerned over the difficulties experienced by American companies in gaining a foothold in the newer oil fields which hold much of the oil supply of the future.

The development of many of the important mineral resources of the world has taken place under concessions. In China, Mexico, and South America, concessions have been granted for the exploitation of minerals by outsiders. The rich resources of Central Africa, which include copper, gold, diamonds, tin, iron, bauxite and many other minerals, are also being developed under concessions of enormous size, held chiefly by companies under the control of Belgian and British capitalists.

Japan and the Control of Manchuria.—It must not be thought that the international struggle for colonies, protected areas, and concessions is a matter of remote times, for the past decade has given us two outstanding examples of attempts by advanced nations to secure political and economic control over backward areas, while the battle for concessions in such areas goes on continually.

In September, 1931, Japan began military operations in Manchuria and, within a comparatively short time, had subdued all of Manchuria, as well as Jehol Province. Manchuria is the old name for the three northeastern provinces of China. It has an

[5] C. K. Leith, *World Minerals and World Politics,* New York, McGraw-Hill Book Company, Inc., 1931, pp. 87, 88.

area of some 365,000 square miles, about equal to that of France and Germany combined, with much fertile agricultural land and important mineral resources. Its population is estimated at 30 to 34 millions. In March, 1932, Manchuria was declared an independent state under the name of Manchukuo, and Henry Pu-yi, last of the line of Manchu emperors of China, was proclaimed its chief executive.

The Case for Japan.—Japan, like other imperialistic nations, had a well-developed set of excuses for its military aggression in Manchuria and its state-creating activities. She contended that civil wars had weakened the central government of China until it was unable to maintain law and order and protect the lives and property of Japanese citizens. She complained of the growth of communism and anti-foreign sentiment in China, and of boycotts applied by Chinese citizens to Japanese products. She charged that China was seething with propaganda against Japan and had violated certain treaty rights and committed many outrages.

According to Japan, her military activities in Manchuria were purely defensive, and were engaged in merely to protect the lives and property of her citizens. She claimed to have no territorial or colonial ambitions whatsoever in Manchuria. She held that the Manchukuo government was created by the people of Manchuria and that Japan had simply aided these people in expressing their will. She protested that Manchuria had never been an integral part of China and had never been actually governed by China, and that the new government would be one of benevolence and justice which would extend the economic "open door" to all nations.

The Case Against Japan.—Apart from the Japanese, few people have found these arguments convincing. The Lytton Report on Manchuria to the League of Nations in 1932 charged that the Manchukuo régime was a Japanese device, and that the Chinese inhabitants of Manchuria, making up some 95 per cent of the population, were strongly opposed to Japanese domination. The report stated that Manchuria should continue to belong to China, but that a way should be found to protect Japan's interests in the district. Many people are convinced that the present government of Manchukuo is but a puppet government, and that the district is quite as much a possession of Japan as though it had been formally annexed. In spite of all Japanese protestations concerning the open-door policy, they expect Japan to exercise practically

exclusive control over the economic development and international trade of the new state, and it seems to them that Japan used whatever events came to hand as excuses for aggression in Manchuria.

But Japan's activities in China did not end here. Again in 1937, taking advantage of a convenient anti-Japanese "incident," Japanese armed forces invaded China and overran large additional sections of the country. In this case, however, the Chinese put up a determined resistance, and a year and a half after the invasion the result of Japan's latest adventure in China was still in doubt. This time, as on previous occasions, Japan protested loudly that her activities in China were defensive in character, but many foreign observers were convinced that this was but an attempt to dress up the wolf of imperialism in sheep's clothing.

Italy and Ethiopia.—The conquest of Manchuria by Japan in 1931 and 1932 had its counterpart in the conflict between Italy and Ethiopia in 1935 and 1936. Italy claimed that she was protecting Italians and their property from the barbaric Ethiopians, and avenging border outrages which had proved humiliating to the national pride of Italy. So, in October, 1935, Italy sent her army into Ethiopia, and had conquered the whole country in self-defense by May, 1936. She did not bother with such unnecessary display as setting up a new government for Ethiopia. She simply annexed the whole country as an Italian colony, and defied the other nations of the world, individually and collectively, to do anything about it.

Ethiopia, Italy's new colony in northeastern Africa, has an area estimated at 350,000 square miles, and a population of some 10 million people. Though large parts of the country are scarcely fit for habitation by whites, Ethiopia's agricultural and mineral resources are imposing and practically undeveloped. It was probably these resources which particularly attracted Italy, in view of her great desire for empire. In any case, Italy, by her annexation of Ethiopia, has apparently established a new all-time record for vigorous "self-defense," unless indeed events in China should show that first honors of this kind must be awarded to Japan.

The Results of Imperialism

In general, we must conclude that the results of imperialism have been unsatisfactory. Nations have gained much by industrialization and by drawing upon other parts of the world for food, raw materials, markets, and relief from population pressure,

but they have gained little through their attempts to reach these ends by annexation or similar measures. In support of this conclusion, let us examine in turn the advantages which nations are supposed to derive from their colonies or other controlled areas.

Relief from Population Pressure.—In many cases, the colonies acquired by industrial nations have served but poorly as outlets for surplus population. As one writer puts it, Italy exhausted herself for many years before the World War to obtain colonies, but when in 1914 the war broke out there were only 8000 Italians in all of her African colonies—a smaller number than lived within a radius of a quarter of a mile of Cherry Street, New York City, and only two per cent of the Italian population of the State of New York.[6] He predicted that, giving Italy complete conquest over Ethiopia and freedom of immigration to the United States, 500 Italians would come here within a year for every one who went to Ethiopia.

Germany's experience was similar, according to this writer. By 1914 she had only 22,000 German colonists in her 900,000 square miles of African colonies, and only 2000 more in all the rest of her colonies. At the time, there were more than 24,000 Germans between 80th and 90th Streets on Manhattan Island, and 25 times as many in New York State. Japan, at a cost of 300,000 men, won South Manchuria from Russia in 1905. Twenty-five years later there were only 200,000 Japanese in this territory, or fewer than were killed in the war, and only one-third of the annual increase in the population of Japan.

There is considerable evidence to show that the inhabitants of advanced countries are much more likely to move to other independent civilized countries than to their own colonies. Many colonies acquired by nations in recent years are almost uninhabitable for the people of these nations, or are already densely populated by natives. Even when conditions in the mother country and colony appear to be fairly similar, it is often difficult to stimulate emigration. Thus, the Japanese declined to emigrate to South Manchuria because of lower standards of living there, because the climate was somewhat more rigorous, and because their favorite food, rice, could not be grown readily in all parts of the colony—and this despite the expenditure of large sums by the Japanese Oriental Development Company to encourage emigration.

[6] Nathaniel Peffer, "The Fallacy of Conquest," *Harper's Magazine*, January, 1936, pp. 129-136.

Of course, some nations acquired colonies long ago which were more suitable for colonization, but most of the recently acquired colonies have failed to attract large numbers from the mother countries.

We may note here the fact that the nations which talk most and loudest about the pressure of population and the need for room to expand—such as Italy, Japan, and Germany—are not, after all, unusually densely populated. These three countries have a population of 133, 135, and 140 persons, respectively, to the square kilometer, while Holland, England and Belgium have 232, 264, and 266, respectively.[7] There are, to be sure, some differences between these countries in their per capita holdings of arable land and natural resources. But it is likewise true that those countries which complain most about population pressure seem to go out of their way to increase this pressure by imposing taxes upon bachelorhood and offering money or other prizes for extraordinary achievements in fecundity.

Food and Raw Materials.—The value of colonies as sources of food and raw materials has been somewhat greater than their value in providing relief from population pressure, but even here it is easy to overestimate their importance. While access to raw materials is vital to industrial nations, it should be remembered that colonies do not grant monopoly privileges, but merely give the mother countries first claim upon such materials, plus some profit from their exploitation. Very seldom do the colonies of any one country have anything approaching a complete monopoly over an important raw material or resource; and even if they should have exclusive control, the abuse of such monopoly power would almost surely lead to retaliation by other nations. Control over raw materials is of little use to an industrial country unless it has markets for its manufactured products, and these depend upon the development and efficiency of its industries. If a country is so efficient industrially that it can command foreign markets, it can usually secure its raw materials and foods more cheaply by purchasing them in the world markets than by conquering and developing colonial sources of supply.

Indeed, industrial countries have seldom, if ever, found themselves discriminated against in the matter of access to foods and raw materials, except in time of war. It is doubtful if any colony

[7] These statistics, as of the last census, are from *The Economist*, London, England, April 18, 1936.

has ever declined, because of a request of the mother country, to furnish these products on equal terms to all industrial nations. At times, the control of raw materials has made things difficult for all industrial nations, but not for any country in particular. But, it may be asked, are not colonial sources of supply important in time of war when other sources are cut off? The answer is that such sources of supply are of no value at such times unless the mother country controls water or land routes to its colonies, and such control is becoming increasingly hard to maintain.

Markets.—Colonies are of some value as markets for products of the mother countries, but here again their importance is easily exaggerated. Colonial trade is often captured by foreign countries which have the special advantages of unusual efficiency or of favorable location with respect to the colonies. We may cite, by way of example, the inroads of the Japanese textile industries upon the trade of the British colonies. Moreover, colonies in their original state are of little use as markets for the mother country; and an economic and industrial development which would enable them to buy extensively from the mother country is likely on the contrary to make them better able to supply their own needs.

This point is illustrated by the fact that, by 1934, Japan was already reported to be uneasy about the development of new industries in Manchukuo which had begun to compete effectively with similar industries in Japan. Low wages in Manchukuo were said to have given that country advantages in the production of iron and steel, flour, soy bean products, and the brewery products. Japan was particularly disturbed over plans for new cotton and wool mills in Manchukuo.[8] In any case, the extent of colonial trade would be difficult to underestimate. In 1934, England's trade with her colonies, except those which are wholly or partly self-governing, amounted to only 10 per cent of her exports and 7 per cent of her imports, while Germany's colonial trade in the pre-war years of 1912 and 1913 amounted to but 6/10 of one per cent of her exports and ½ of one per cent of her imports.[9]

The Question of Concessions.—Concessions obtained by industrial nations in regions which are not politically controlled often appear to be economically justifiable. They may permit the development of backward regions, while retaining a considerable degree of control for, and bringing in some revenue to, the con-

[8] *Ibid.*, June 9, 1934.
[9] *Ibid.*, April 18, 1936.

ceding government. To avoid controversy, they should be given for definite periods of time and for well-defined areas only, with adequate safeguards for the nations granting the concessions. It is particularly important, moreover, that they be granted according to the principle of the "open door." That is, the people of different nations should all have opportunities to obtain these privileges. When concessions are inexactly defined, and unequal opportunities are given to the people of different nations, international rivalry is stimulated and bitter diplomatic conflict often results, which may at any time lead to more serious international conflict. The United States has often been involved in trying to protect American concessions and concessionaires in backward areas from hostile treatment by the governments of these regions, or from the depredations of bandits or revolutionary elements. We have at times landed our marines and engaged in actual combat with armed forces which presumably endangered the safety of our properties and citizens, and have taken over or supervised the revenue systems of backward areas in order to safeguard our interests. Such activities are, of course, dangerous from the inter national point of view.

Final Estimate of Imperialism.—In general, then, the fruits of imperialism have not come up to expectations. Often the policies of industrial nations in backward areas have failed to bring these nations the expected economic advantages. And when successful in this respect, they have frequently led to international friction and ill feeling, and to the development of retaliatory policies and devices. Doubt and fear pervade the atmosphere in a world where the distribution of vital supplies of food and raw materials is left to such instruments as discriminatory tariffs, imperialistic policies for undeveloped areas, and monopolies and control of raw materials. Moreover, international resentment is likely to lead nations to substitute a suddenly destructive course of action for one which is only gradually destructive of economic welfare. In other words, economic warfare may give way to military warfare, to the lasting detriment of all nations concerned.

The Control of Raw Materials by Producing Nations

Though our discussion has related specifically to the attempts of industrial nations to control sources of supply, we must not overlook the fact that the areas producing food and raw materials have themselves taken a hand in playing the game of restriction-

ism. While raw material controls have sometimes apparently been set up by groups of individuals or companies in the producing areas, it is usually true that the governments of these areas are genuinely, even if indirectly, interested in the proceedings.

The Conditions for Control.—The effective control of a raw material by producers is possible only if certain necessary conditions are met. In the first place, the commodity should be one which originates largely in a single country, although control has sometimes been made effective through the cooperation of two or more producing countries. Again, the material should be capable of being stored over considerable periods of time without deterioration, so that it can be withheld from the market indefinitely if necessary. Thirdly, the principal demands for the material should come from prosperous areas where the burden of rises in price which may occur will not be likely to stir up trouble for the controllers. Finally, the material should be such that new sources of supply cannot be developed except over a considerable period of time. Of course, if the commodity is a mineral which occurs almost entirely in a single area, potential competition is not much to be feared. Among vegetable products, however, those most easily controlled are commodities such as coffee and rubber, in which competition can develop only over the period of six or seven years which is required to bring a plantation into profitable operation.

The Purposes of Control.—The principal object of the control of most raw materials is revenue for both the government of the producing country and the individual producers of the goods in question. The government usually obtains its revenue through an export tax on the raw material. Such a tax is likely to be particularly heavy when the country has a virtual monopoly of the desired good, for then the burden of the tax will tend to be paid by the users abroad. Occasionally such a control will take the form of a governmental monopoly, and in such cases the revenue for the government is derived from the enhanced prices which the control permits.

The revenue for the producers of the raw material comes from the high prices which they can charge when the production or marketing of the material is regulated under the control scheme. The participation of the government in the plan may run all the way from the mere collection and dissemination of information or the development of a plan for cooperation by the producers, to the passage of legislation for the restriction of output or the main-

tenance of prices. At any rate, the operation of control plans has often resulted in greater profits for the producers, or has at least permitted them to avoid losses which might otherwise have occurred.

Since these controls are almost never used by industrial nations, but are instead the product of regions which are economically undeveloped, a third purpose of control is sometimes present. This is to protect and encourage the domestic industry utilizing the raw material in question. Of course, the most common method of protecting an industry is to impose an import duty on the finished product. The same result, however, may be reached, especially when the raw material is largely located in one country, by insuring, through a control plan including an export tax, that the users of this material abroad will receive it on less favorable terms than domestic manufacturers. At times there appears to be no intention of building up an industry in the region producing the raw material. In such cases, if the region is a colony, the manufacturing industry in the mother country is often fostered instead by means of a rebate of a portion of the export tax applied to the raw material.

The Control of Raw Materials by Producers.—The various raw material controls may be divided into four groups, according to the degree to which the government of the producing country is interested in the plan. In some cases the control is left for the most part to the producers, with the government taking an indirect interest in the proceedings. An example has been the Chilean control of nitrates. Some form of nitrogen is essential in the production of fertilizers, dyes, drugs, and explosives. For many years the only large source of nitrates was the deposits of sodium nitrate in Chile, and the producers have long been organized for the control of this important material.

Their organization was called the Chilean Nitrate Producers' Association, and it controlled the production, sales, and prices of over 90 per cent of all sodium nitrate sold throughout the world. The policy of the Association has been, in general, to charge as high prices as the traffic would bear, and they have certainly been well above those which might have been expected to prevail under conditions of competition. Earnings on invested capital amounting to 25 to 50 per cent and higher have been reported.[10] The Asso-

[10] B. B. Wallace and L R. Edminster, *International Control of Raw Materials*, Washington, Brookings Institution, 1930, p. 50.

ciation has also restricted production whenever it has been deemed necessary.

The Chilean government has manifested its interest in the industry in many ways. In 1919 and 1921 it approved the statutes of the Association, and it has assisted in bringing producers into the Association. The government has been represented by four members out of the eighteen on the Association's board of directors, and has assisted the industry through reductions in railroad rates and exemptions from import duties on the bags used in shipping nitrates. Nevertheless, the participation of the government in this control has not been so direct and obvious as in other cases in which raw material controls have been provided for by legislative enactment and governments have bought up and withheld supplies of raw materials from the market. It is also true that the heavy export duty imposed upon nitrates by the Chilean government has been a great burden on the industry at times. This duty has usually amounted to a third or a half of the export value of the nitrates. Though its incidence has probably been in part upon the producers, a large part has also been borne by the consumers, many of whom are in the United States. One writer states that this duty over a period of years has cost American consumers about ten million dollars annually.[11]

Competition between Chilean nitrates and nitrogen from other sources became keen in 1927. Manufactured nitrogen, obtained from the air by a process of "fixation," is the principal source of this competition. Conditions became so serious in 1929 that a three-sided agreement was made between the Chilean Nitrate Association and English and German producers of synthetic nitrogen products. This new combination has control over practically all nitrogen production and is undoubtedly able to control production, divide up markets, and fix prices according to the best interests of the parties in control.

Raw Material Control by Legislative Enactment.—The severe depression in the rubber industry following the World War, and the failure of attempts to promote voluntary cooperation among the growers, led to the passage of legislation in British Malaya and Ceylon in 1922 which has come to be known as the Stevenson Restriction Act. The purpose of the Act was to bring

[11] W. S. Culbertson, "Raw Materials and Foodstuffs in the Commercial Policies of Nations," in *Annals of the American Academy of Political and Social Science*, March, 1924, p 80.

back prosperity to the rubber growers by raising prices through the restriction of exports and control of production. The operation of the Act was somewhat complicated. Each plantation was assigned a "standard production" based upon its production for 1920, with allowance for new areas. "Standard production" for most estates probably ran around 80 to 85 per cent of capacity. Exportation at the minimum rate of export duty was permitted to each plantation up to a certain percentage of standard production. For greater amounts, the export duty became so heavy as to prohibit exports, for all practical purposes. The percentage of standard production which could be exported at the minimum rate of export duty varied as the price of rubber in London oscillated around a "fair price" per pound.

The Stevenson Act had the effect of restricting the output of rubber, at least temporarily, and also encouraged speculation in rubber. It was successful in stabilizing conditions in the industry and in bringing prosperity by raising prices, but just how much credit for the rise in prices should go to the Act and how much to other factors is not apparent. At any rate, the spot price of rubber in New York rose from a low of 13.9 cents a pound in August, 1922, to the high mark of $1.048 a pound in November, 1925, and then fell to 18 cents in December, 1928.[12] During this period, immense profits were made by the rubber producers. Dividends for British rubber companies, which had ranged between 6 and 12.5 per cent in 1923 and 1924, varied between 17.5 and 55 per cent in 1925 and 1926. One estimate has it that this raw material control cost the United States about $540,000,000 from 1924 through 1926.[13] Part of this extra cost was borne by the manufacturers of rubber articles in this country and part was passed on to consumers.

The decline in the price of rubber after 1925 was the result of several forces. The anxiety of American industrial consumers over future supplies of this raw material was to some extent alleviated; world production of rubber was steadily increasing, especially in non-British areas where the control did not apply; and the demand for crude rubber was lessened by means of the greatly increased use of reclaimed rubber. The Stevenson Act aroused a chorus of protest, with the United States as chief

[12] B. B. Wallace and L. R. Edminster, *International Control of Raw Materials*, pp. 188, 189.

[13] *Ibid.*, pp. 212, 213.

protestant. The Act was finally repealed in 1928, when it became evident that it had outlived its usefulness. This does not necessarily mean, however, that all plans for the control of rubber are at an end.

Control Through Government Aid to Producers.—Probably the best example of this type of control was the Brazilian control of coffee. This plan was provided for by legislative enactment, but it differed from the control of rubber in that direct financial aid was given by the government to the coffee growers. After three successful "valorizations" of coffee, during which coffee was bought up and withheld from the market and restrictions were placed upon its export and the planting of new trees, a plan for the "permanent defense" of coffee was adopted. The law providing for such defense was passed in 1922, but the national government withdrew in 1924 and the measures for the protection of coffee were put into operation by the State of Sao Paulo in 1925. Control was placed in the hands of the Institute for the Permanent Defense of Coffee, which was composed of five members.

The main purpose of the permanent defense was the stabilization of prices through the regulation of the amount of coffee coming on the market. The State of Sao Paulo owned an extensive system of warehouses, in which some 8 million to 12 million bags of coffee could be stored until market conditions permitted their sale. Planters were required by law to turn over all their coffee to the warehouses of the Institute, and at times were able to get as much as 75 per cent of its market value as a loan from the government. Funds for loans to the planters and for general expenses were obtained both by borrowing and by taxation.

By these methods it was possible for the Institute to maintain a high level of prices for some time. Until 1927 no great accumulation of coffee in the warehouses took place because world consumption was keeping pace with production. Beginning with the bumper crop of 1927-28, however, production far outstripped consumption, and prices could be maintained at anything like a satisfactory level only by amassing a tremendous surplus of coffee in the warehouses of the Institute. It was expected that by the middle of 1930 this reserve would be only just short of the amount annually consumed in the world. The strain proved too much for the credit of the Institute, and the price of coffee collapsed late in 1929. All Brazilian banks were in dire straits because of frozen

assets, and the situation was saved only by obtaining an immense loan from abroad, secured by coffee and by a promise that in the future crops would be marketed as they were harvested and not withheld from the market. Some further control may be necessary, however, in view of the large surplus on hand and the ample crops that are coming in every year.

Control by Governmental Monopoly.—It is only a step from control through a governmental plan, with public funds and facilities, to control by governmental monopoly. An example of the latter type of control is the Japanese camphor monopoly. Camphor is at present used chiefly for the making of celluloid, and the moving picture industry is consequently dependent upon it. Camphor is also an important element in the manufacture of pyroxylin products, including non-breakable or shatterproof glass.

The monopoly control of camphor has been carried on with a dual purpose. It was desired, of course, to bring in revenue for the government, and it was hoped that the domestic manufacture of refined camphor and camphor products would be encouraged. The Japanese government has complete control of the industry. No one can go into the forests to collect raw camphor by distillation of the wood of the camphor laurel tree except operators licensed by the government. Thus both the quantity to be produced and that to be sold at home and abroad are arbitrarily determined. In addition, the government sets both the price for the sale of camphor and the price to be paid to the operators who collect it.

The monopoly has been moderately successful in maintaining prices above those which might have prevailed under competitive conditions. The price of camphor doubled within two years after the establishment of the monopoly, and prices have been well maintained in the face of constantly growing production and sales. The power of the monopoly to set a high price has been weakened in recent years by the competition of synthetic camphor, made from turpentine. Since it is now possible to produce synthetic camphor, which can be widely substituted for natural camphor and is even preferred for some purposes, on a commercial scale, the price policy of the Japanese monopoly has been greatly modified. In any case, the importance of camphor is not so great that the maintenance of prices would arouse any storm of protest from the nations that use it, as happened in the case of the rubber and coffee controls.

Control by an Embargo on Exports.—More drastic even than monopoly control of a food or raw material is an embargo on the export of some material. Probably the example of an embargo of this kind which comes most promptly to American minds is the Canadian embargo on pulpwood. The object of such a restriction is not, of course, to bring in revenue for the government or to enhance the prosperity of the producers of the material, but rather to stimulate the growth at home of the industry which uses the raw material under restriction. For this purpose, an embargo may be very useful, but its effect upon a similar industry abroad may be serious.

The important restrictions were imposed by the provincial governments rather than the Dominion government, and varied from one province to another. They were unanimous in imposing embargoes on the exportation of pulpwood taken from crown lands, however. Sometimes the restrictions applied partially to pulp as well. At any rate, they made it necessary for pulpwood to be turned into pulp or even into paper before it could be exported. These embargoes were a source of great anxiety to the American paper industry, especially in the East. Our domestic supply of pulpwood has in many districts become entirely inadequate, nor can it be moved for long distances to be manufactured because of the great cost. Many of our paper mills are dependent upon Canadian sources for much of their pulpwood, and if the embargoes were extended to apply to pulpwood from all Canadian lands or to require the manufacture of wood into paper before exportation, serious results in this country might be expected. It is true, however, that the restrictions appear to be accomplishing their purpose in Canada, for her exports have changed more and more from pulpwood to wood pulp and finished paper.

The Results of Raw Material Control by Producing Countries.—Our estimate of these types of control over raw materials must be much the same as that of the control of industrial nations over the sources of raw material. At times they have accomplished the results desired by the producing countries, and again they have not. On the other hand, they have been resented by countries that need these raw materials, suffer under the present burden of the controls, and visualize a time when they may be cut off wholly from their supplies of raw materials. Like the devices used by imperialistic nations, they constitute, therefore, a potent source of international friction and ill will.

Future Prospects of Goods Control

The National Approach.—We have yet to consider what can be done about the problems resulting from the economic interdependence of nations. In general, little success seems likely to attend the efforts of any one nation to deal individually with these problems. The United States, for example, can do little to improve its position in connection with a situation such as the Chilean-British-German control of nitrogen products, the recent British colonial restriction of rubber, or a preferential tariff intended to exclude us from colonial markets—for the activities to which we take exception are carried on outside the jurisdiction of this country.

Action has sometimes been taken in the United States to try to improve the raw material situation, but little has been accomplished. Congressional investigations have been conducted and occasionally funds have been appropriated to promote the production in this country of materials which have been subjected to control by foreign countries. When public denunciation of some type of control has been particularly vigorous, the Department of Justice has brought suit against the American agents of foreign monopolies in the attempt to restrain their activities, but the suits have seldom been successful. The government has also been instrumental in preventing in this country the flotation of loans for the benefit of foreign material and food controls, but these loans have never failed of flotation in some other country or countries.

The principal nationalistic alternative to such feeble attempts at relief is retaliation, with control matched against control and restriction against restriction. As we have seen, however, retaliation is a dangerous policy. It almost never helps solve the original problems but, on the contrary, complicates them. There is no nation so strong that it can bring economic pressure to bear upon other nations without fear for itself, or so rich in economic resources that it can be prosperous without placing a considerable amount of economic dependence upon other nations. If each nation could carry the control of foods, raw materials, and markets to the *n*th degree, the result would be the destruction of international exchanges, and economic disaster for all.

International Distribution of Raw Materials.—It is clear that a new approach to the problem of the economic interdependence of nations is needed, and that this new approach must

be international in character. It is believed by some that the actual distribution of food and raw materials should be undertaken by an international organization. That is, the ownership of the raw materials and foodstuffs of the world would be vested in a central organization which would distribute them in an equitable manner among the nations. A system similar to this was used during the World War, but it would be difficult to get the nations to agree to it in times of peace. A second difficulty would be found in trying to build up a workable distinction between raw materials and other products. Most troublesome of all, however, would be the formation of principles of equitable distribution, and the decisions as to prices to be charged, when the total supplies of certain materials were concentrated in the hands of this central organization. These obstacles may not be insuperable, but it appears that a more helpful and comprehensive approach may be devised for the present situation.

The International Approach Through Freer Trade.—An understanding of a few fundamental facts concerning the world of today is the basis upon which the international approach rests. For political purposes the world is divided up into many units called nations, but for economic purposes the world itself is a single unit. Cooperation among the national political units is essential if the economic welfare of all peoples is not to suffer. Nations make economic gains with other nations. It is next to impossible today for one nation to gain at the expense of another, just as it would be difficult for a man's arm to gain by inflicting a severe wound on his leg. Trade restrictions and raw material controls, like chickens, come home to roost. When applied by all nations, they aid materially in reducing the economic welfare of all peoples.

Past Progress.—The solution of our problem, then, is freer trade among nations. Already some slight progress has been made in this direction, besides the almost universal condemnation of control and restrictions by meetings of many international organizations. Out of a Diplomatic Conference held at Geneva (Switzerland) in 1927 came a Convention for the Abolition of Import and Export Prohibitions and Restrictions. This agreement was signed by eighteen nations, who were later joined by the United States, and in it the nations contracted to abolish within a period of six months after the agreement went into effect all import and export prohibitions and restrictions and promised not to impose them in the future. The convention did not apply simply to restrictions

on raw materials and foods, but to all kinds of restrictions, with the exception of import and export duties and measures calculated to protect the public health and other vital national interests.

Further Needs.—The weakness of this agreement is apparent, for an attack on import and export duties is necessary if any real solution of our problems is to be achieved. Free trade would go far toward bringing such a solution. The industrial nations would be assured access to foodstuffs and raw materials upon terms as favorable as those granted to any country, and would be able, if sufficiently efficient in production, to obtain markets in any part of the world. The benefits from free trade are likely to be greater and more cheaply secured than any gains which might possibly accrue from the adoption of imperialistic policies and adventures in restrictionism. It appears, then, that the solution of the problems discussed in this chapter is tied up with modifications in our tariff policy as recommended in Chapter 11. Hence, the steps which are being taken in this direction should be warmly applauded by the citizens of all nations.

There is need, also, for more agreements between countries dealing in specific terms with materials and markets. These agreements would provide guaranties among industrial nations to the effect that their colonial possessions would not discriminate against any country, with respect to access to food and raw materials. Similarly, the nations should agree upon the open-door policy in developing trade with colonial areas, so that this trade would depend upon advantages in efficiency and location and not upon artificial advantages. It would be more difficult, of course, to reach agreements providing for the free movement of population from one part of the world to another.

Freer trade, bolstered up by specific agreements, might make the position of the industrial nations less secure in time of war, but developments such as these should do much to lessen the probability of wars. Regardless of the specific devices adopted for the purpose, it is apparent that the solution of our international economic problems awaits a realization by the nations that the whole world is for economic purposes a single unit—one body with many parts. The time has come for a larger degree of cooperation among the several parts of this body, with each part performing well the functions for which it is fitted, without aspiring to other functions. At present, in our economic world, the feet are trying to think and the brain to walk. Most important of all is the recog-

nition of the fact that attacks and defenses, discriminations and retaliations between the different parts of the same organism can result only in weakness and ill health, whether the organism is an individual human body or a world society of human beings.

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1. What has been the relation between population growth and industrialization?
2. How have industrialization and the development of large-scale production led to economic interdependence among nations?
3. Many persons have claimed in the past that the United States could be self-sufficient, and need depend on no other country for her economic welfare. Do you agree? Why?
4. Why have colonies been sought by the great industrial nations?
5. What are the two tariff policies which nations have commonly adopted in connection with their colonies? Distinguish carefully between them.
6. What is the difference between a colony and a protectorate? Between a protectorate and a mandate? Explain.
7. What is a concession? Of what importance are concessions in our modern economic world?
8. Describe two recent attempts of industrial nations to acquire control over backward areas by means of conquest.
9. Have colonies generally been helpful to industrial nations in affording relief from population pressure? Explain.
10. How important have colonies been to industrial nations as sources of foods and raw materials? Explain.
11. Have colonies generally solved the mother countries' problem of finding markets for manufactured products? Explain.
12. How have imperialistic policies affected the relations between industrial nations?
13. Why have controls over raw materials been instituted by many countries producing raw materials? Explain.
14. Under what conditions are these controls most likely to succeed?
15. What has been the basis, in this chapter, for classifying controls exercised by producing countries over raw materials?
16. Give an example of each type of raw material control.
17. What have been the results of controls over raw materials by producing countries?
18. Why has the national approach to the problems of the economic interdependence of nations been both ineffective and dangerous?
19. What difficulties are involved in the plan for the international distribution of raw materials?

20. What progress has been made in the past toward the solution of the problems created by the economic interdependence of nations?
21. What appears to be the most promising method of approach to these problems in the future? Why?

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PROBLEMS OF SOCIAL WASTE

14 WASTE IN PRODUCTION

MUCH HAS BEEN SAID AND WRITTEN IN PRAISE OF AMERICAN BUSINESS. WE HEAR A GREAT DEAL ABOUT THE EFFICIENCY OF production in this country. We read from time to time about improved methods of manufacture. And we see in books, magazines, and newspapers, imposing figures of exports from the United States to foreign countries—exports which, we are told, represent goods that Americans have made over and above those required for their own use.

Most textbooks on economics, also, tend to emphasize the possibilities of our present-day productive methods. Descriptions are given of measures that have been adopted to increase the effectiveness of man's efforts to convert raw materials into consumers' goods. These measures include the use of the roundabout process of production, strict attention to the most economical arrangement of the productive agents, specialization in its various forms, and, in some instances, the adoption of large-scale methods.

But we must not get the impression that all is efficiency in American business circles, for such an impression unhappily would be erroneous. To lessen the danger of getting a lopsided picture of the situation, we shall point out in the present chapter certain shortcomings of our business enterprisers which result in a very serious economic loss to individuals and society as a whole, and to the present and future generations.

The Nature of Waste in Production.—Writers on economic principles usually define production as the creation of utility, and discuss in some detail the several types of utility—*form, place, time, possession,* and *service*—which are being created constantly by our great army of workers. Efficiency in production demands that these workers shall be kept employed steadily, and that the conditions under which they work shall be such as will enable them to make the most of the land and capital with which their labor is combined in making, transporting, storing, and selling goods, or in performing some other act of production.

Success in production depends upon the possession of knowledge of the best methods of production, whether in manual work or in management, and upon translating that knowledge into action. Land, labor, and capital are scarce agents of production. Whenever any of these agents is allowed to go idle, being wholly or partly unused, there is economic waste. Whenever business men are ignorant of or for some reason fail to apply the best-known methods of production, there is waste. Whenever productive agents are used in a way which yields a smaller return in output than could be had through some other use of these agents for the same length of time in the same field of production, there is waste. And whenever a valuable, irreplaceable natural resource (such as coal) is used when a relatively inexhaustible resource (such as water power) would serve equally well, obviously there is waste. We may define waste in production, then, as *any economic loss suffered by society through the inefficient use of factors of production, or through the failure of enterprisers to use certain of these factors when, from the social point of view, it would be economically wise to do so.*

Professor John A. Hobson and other writers have argued that some enterprisers indulge in waste through the production of goods which are socially undesirable, and which therefore constitute "illth" instead of wealth. This is a matter which we cannot undertake to discuss at this point, though it will receive attention in later chapters.[1] We are here concerned primarily with the efficient production of whatever goods are turned out, and not with the way they may affect society when they are consumed. Judging purely by our definition of waste in production, we should have to commend the producer of illth, provided he produced efficiently; while at the same time we should be obliged to condemn the producer of much-needed goods, if he was less efficient in his methods than the best enterpriser in his particular field of activity. For the problem of waste in production is solely one of the unwise utilization of the agents of production—land, labor, and capital.

Conflict of Individual and Social Interests.—In many cases, a reduction in waste in production results in both individual and social gain. When, for example, an enterpriser lowers his costs of production through the more efficient use of coal, he not only adds to his personal profit but also promotes the conservation

[1] Chaps. 15 and 16.

of an important natural resource. But there are instances in which productive methods, though socially wasteful, may be individually profitable. It may pay the owner of oil land to drill and pump feverishly to obtain oil which would otherwise be secured by owners of adjoining plots of land, just as it may pay a monopolist to restrict his output in order to charge an artificially high price for his product. But if the oil man thus renders impossible the *total* maximum production of oil from this field, as he may easily do, and if the monopolist in practicing restriction allows machinery and labor to go idle, both of these producers would clearly be engaging in anti-social acts; for, judged by the standards set up in our definition, both would be indulging in waste in production. In such instances, as always in the study of economics, we are bound to take the social point of view and to condemn self-seeking individuals for their unsocial actions.

Some Major Examples of Waste

We shall now make a brief, and necessarily a very incomplete, survey of the waste of land, labor, and capital in some of the more important phases of economic life. Unfortunately, we have almost nothing to offer in the way of *exact data*, for the reason that such data are not to be had. The field is so huge and so varied that we can never hope to secure complete information on the extent of waste in production. But the figures that we present are as good as any that are obtainable. They are, it should be said, *careful estimates* made by men who have given much study to the matter. And even if they are only "enlightened guesses," they are nevertheless sufficiently accurate to give a fair idea of the serious problem which we, as a society, face. With this word of explanation, we proceed to an examination of certain types of waste in production.

THE WASTE OF LAND

Land is defined by the economist as natural resources created without the assistance of labor. Since land is synonymous with natural resources, we shall concern ourselves, in the present section of the chapter, with examining the wasteful exploitation of some of our important natural resources. Over the extent and solidity of land, and over climate, man has little or no control; but in the case of properties of the land such as minerals, water

power, natural vegetation, and soil fertility, man has it within his power to use them wisely or unwisely.

The importance of using natural resources economically, instead of wastefully, will be apparent when it is remembered that production consists of converting natural resources, directly or indirectly, into consumers' goods. If there should come a time when we have completely exhausted our stock of natural resources, we shall then be through with production as well, and shall have put an end to the possibility of making consumers' goods.

Coal.—One of our most important natural resources, because of its use in producing power and heat, is coal. We have in mind, of course, not anthracite or hard coal, but the bituminous or soft coal of which we use a half-billion tons a year, and upon which we depend to drive our locomotives, generate much of our electricity, provide coke and its by-products, and turn the wheels of an overwhelming majority of our industrial machines. And yet we treat this great natural resource as though we possessed unlimited quantities of it.

We have it on the authority of experts that for every ton of bituminous coal that is brought to the surface, another ton is left in the ground, forever beyond reach.[2] The cause is faulty mining. Apparently with no thought for the probable needs of future generations, most operators of soft coal mines practice "creaming the mine," which consists of following the rich seams of coal, taking out only that which is readily accessible, and abandoning the mine before the lean seams have been worked. After a time, the roof of the mine falls in, and what would once have been a somewhat difficult task of mining becomes virtually impossible. Systems of leasing which prevail in mining are also partly responsible for the neglect of thin seams and other high-cost areas; for the leases often call for the removal of a specified quantity of coal each year, and hence encourage the mining of those parts of the mines that may be most easily and cheaply exploited.

In the use of bituminous coal, once we have delivered it at the boiler room, we are exceedingly wasteful. According to the late Charles P. Steinmetz, the "electrical wizard," we lose three-quarters of the power and heat of every ton of coal that we burn, through faulty utilization. Another estimate is to the effect that

[2] C. G. Gilbert and J. E. Pogue, *America's Power Resources,* New York, D. Appleton-Century Company, Inc., 1921, p. 20.

"the average steam plant uses eight times as much coal per unit of power generated as does the most efficient plant";[3] and in the opinion of Mr. Stuart Chase, "two tons are being burned where one or less would suffice."[3] All in all, it seems very likely that if we set ourselves seriously to the task of conserving coal we could, by employing the best-known methods of mining and utilizing coal, satisfy our present needs and yet reduce the drain upon our stock of this natural resource by at least 75 per cent.

Petroleum.—The importance of petroleum has been brought home to us by the development of the internal-combustion engine, with gasoline for fuel, which during the past two decades has played so vital a part in both peace and war. Petroleum is of great significance, also, as the source of a score or more of useful commodities, including kerosene, benzine, naphtha, asphalt, and paraffine. It provides us with most of our lubricating oils—a matter of prime importance in a machine age. And petroleum, in a relatively crude state, is being used in increasing quantities as fuel for locomotives, steamships, and industrial plants, and for purposes of domestic house-heating.

Our record for waste is even worse in the exploitation of petroleum than in the mining of coal. Because petroleum collects in underground "pools," spreading over wide areas, it is possible for a landowner, by drilling into the pool, to secure not only the oil immediately under his own property but also—if not interfered with—much of that which lies under surrounding acres, since it will tend to flow or seep through the sand toward the outlet. On this account, the discovery of oil is the signal for all landowners to start drilling at once, in the hope of getting the oil out of the ground before others capture it.

The inevitable result is a needless multiplication of wells and derricks, waste in the form of excess labor, and, worst of all, gross interference with the proper extraction of the petroleum from the land. Engineers say that for the proper drainage of the oil there should not be on the average more than one well for every eight acres of land. But in many instances there is a productive well for every two acres, and sometimes the wells are so close together that the derricks seem almost to touch one another. Because of faulty technique in exploiting our oil fields, it is probable that "for every barrel of oil produced three barrels or more are left

[3] Stuart Chase, *The Tragedy of Waste,* New York, The Macmillan Company, 1926, p. 242.

underground, or wasted in well operation."[4] This waste has been caused by the failure to apply the best methods of production that have been developed. Says the Director of the Bureau of Mines: "We have been wasteful, careless and recklessly ignorant. We have abandoned fields while a large part of the oil was still in the ground. We have allowed tremendous quantities of gas to waste in the air. We have let water into the oil sands, ruining acres that should have produced hundreds of thousands of barrels of oil."[5] And as a consequence of these and other practices it seems certain that we lose a half-billion (and possibly a full billion) barrels of petroleum a year, which we could save if only we did the best we know how to do.

Fortunately, our *utilization* of petroleum is not so wasteful. Indeed, we are probably as efficient in the field of oil-refining as in any of our great manufacturing enterprises, and far more efficient than in most. Refining is in the hands of a relatively small number of large companies, in striking contrast to the widespread ownership of oil lands. These companies, for the most part, have established research laboratories which are constantly improving the technique of refining; and as better methods are developed they are adopted rapidly throughout the industry. Here, then, is one bright spot in an otherwise gloomy picture of inexcusable waste.

Natural Gas.—Closely related to petroleum, in both its occurrence and economic importance, is natural gas. Those who live in regions where this great natural resource is plentiful are well aware that it is both useful and cheap. It is in many respects better than artificial gas made from coal, and is particularly suitable for domestic purposes. And yet this valuable natural product is allowed to blow off into the air to the extent of some 600 billion cubic feet a year, according to reliable estimates. In this way we waste approximately as much natural gas as we utilize. Translated into terms of present average Philadelphia prices for artificial gas, the loss is about $450,000,000 a year. This loss is very largely attributable to our faulty exploitation of petroleum; and much of the waste of petroleum results from the premature escape of natural gas. Hence, if we used scientific methods of oil production, we should at the same time reduce materially the loss that we now suffer through the waste of natural gas.

[4] *Ibid.*, p. 248.
[5] Quoted in *ibid.*, p. 251.

Water Power.—The possibilities of water power for supplying the power, heat, and light needs of the people of this country have been greatly exaggerated. Theoretically, we could increase enormously the amount of electrical power generated by means of falling water, but practically there are very real limits to the extent of such increase. For practical purposes, we should not consider as available for water-power production any streams which cannot be relied upon to provide a steady supply of electric current, nor should we estimate the power possibilities of a stream at an output greater than the minimum which it may be counted upon to generate continuously throughout the year. Furthermore, we should exclude from our calculations the water-power potentialities of those regions which are so remote from centers of population that the current which they might generate could not find purchasers. There are, of course, many excellent streams in mountainous areas which must be ruled out, at least for the present, on this account.

Nevertheless, the fact remains that we have in the United States water-power resources which, from the social point of view, should be developed and put to work. If we consider as "available" only those waters which may be used 90 per cent of the time, we have in this country, according to estimates of the United States Geological Survey, the potentialities for generating some 40 million horse power from water; and of this amount we are now utilizing only about one-third. It seems fair to say, therefore, that we could if we wished secure at least an additional 25 million horse power by harnessing our streams and thus expanding our production of electric current.

That we have not done so is attributable largely to the great cost of constructing hydroelectric plants, but also in part to the fact that bituminous coal has been both plentiful and cheap. Indeed, much of the tragedy of the water-power situation lies in the use of irreplaceable coal to the neglect of water power, which is continually being renewed. As Mr. Chase has put it: "What water power can do is to diminish the annual amount of coal needed, and thus lengthen the life, and help to preserve the by-products, of the coal beds. . . . We have been eating into our *principal*, while allowing a steady and unending *annuity*, in the form of water power, to waste away."[6]

[6] *Ibid.*, p. 245.

Replaceable Natural Resources.—The waste of natural resources which we have been describing is especially serious because it constitutes an irreparable loss. Coal, petroleum, and natural gas once wasted are, for all practical purposes, gone forever, since geological ages instead of years are required for their formation. To be sure, there is always the possibility that satisfactory substitutes will be found, if and when these natural resources are completely exhausted However, it is scarcely the part of wisdom to regard this possibility as justification for wasting these resources, when we know perfectly well how to prevent most of the waste.

Another but less dismal type of waste of natural resources has to do with natural vegetation, fish and game, and the natural fertility of the soil. In our use of these gifts of nature we have been most prodigal. There remains today but one-sixth of the "forest primeval" that was here when the Pilgrim Fathers landed in America. Through careless lumbering, preventable forest fires, and wasteful methods of manufacture, we lose some 5 billion cubic feet of lumber a year. The fish that once filled our streams, and the game that roamed our forests and plains, are now excessively scarce—in some instances because man has had to turn woodland prairies into farms, but all too often because of wanton slaughter or the pollution of rivers and other bodies of water. Our natural soil fertility, which made common a yield of forty bushels of wheat per acre in pioneering days, has given way to impoverished land which, planted year after year to the same crop, now produces but a quarter as much as it should. More pitiful still are those very considerable areas which have suffered erosion by wind or rain and are now wholly unproductive, though once they provided a livelihood for thousands of families.[7]

Without condoning the misuse of these important natural resources, there is no need to regard the situation as hopeless. For the remedy lies clearly within our own control, and may be applied as soon as we recognize our misdeeds and highly resolve to make amends. Not overnight, it is true, but in the course of a generation or so, great oaks from little acorns grow; and forests of oak, pine, and other important varieties of trees will soon be ours, once we undertake seriously to rebuild our denuded forest areas. The reforestation movement, started under the administration of Franklin D. Roosevelt, has already made progress in this direction; but private as well as governmental agencies must join

[7] This and other problems of agriculture are treated in chaps 19 and 20

the movement if we are to provide for ourselves and our posterity an adequate, continually renewed supply of standing timber.

The remedy for the rapid decline of wild life is not so clear. We have done something in the way of conserving this resource by providing "closed seasons," during which fish and game are protected. We have replenished our streams with fish from hatcheries, and encouraged the multiplication of wild animal life by stocking our national parks and state game preserves with needed types of animals and giving adequate protection. We could, and unquestionably should, reduce the pollution of our waters, in the interest of human health as well as the preservation of our supply of fish. But we have, after all, passed the "direct appropriation" stage of economic development, in which man lives chiefly by taking the things provided by nature and using them directly rather than indirectly. In our present-day agricultural and industrial life, it is doubtless inevitable that we should minimize the importance of our wild-life resources and utilize our land in ways which will cause it to yield, acre for acre, more product than we should get if we set apart extensive areas of potential farm land for the development of wild animal life.

The problem of soil conservation is one which has been commanding much attention in recent years. Most people agree that something must be done, and done promptly, to reclaim our wasted agricultural areas and prevent further waste through unscientific farming and erosion. It has been demonstrated clearly that a farm that has been robbed of its fertility may be restored to a high state of productivity, if only the proper measures are adopted. And the necessary measures have been developed and made known by scientists who have devoted their energies to the problems of farming. Chemists, through the analysis of soils, can discover the deficiencies of given plots of land, and prescribe fertilizers that will add to the soil the plant food required for the production of desired crops. And the United States Department of Agriculture and many similar state departments stand ready to advise how to secure the best crops without at the same time impoverishing the soil.[8]

[8] "Among the most important means of increasing the yields of crops are: (1) The selection of crops better adapted to the available soils; (2) the employment of suitable rotations; (3) the use of better adapted varieties; (4) the reduction or elimination of losses from the depredations of insects and diseases; (5) control of weeds; (6) better or more thorough methods of preparing the land and cultivating the crop; (7) larger or more effective use of fertilizers; and (8) the substitution of crops which give a larger yield per acre for those which give a smaller yield"—From *Yearbook* of the United States Department of Agriculture, 1923, p. 464.

There seems no doubt that erosion by water and destruction by floods may be lessened by giving proper attention to reforestation, and that erosion by wind suggests the planting of grasses rather than cultivated crops in the areas that are affected. The problem, however, is one which cannot be solved satisfactorily by individuals, for it involves a consideration of "great drainage areas, big rivers and little waters, dust storms, minerals, gas and oil; climates and different conditions; and the effect upon the earth of roads, bridges, cities, sewer plants and all artificial additions made by society."[9] The Soil Conservation Service was created by Congress in 1936, in recognition of the direct responsibility of the federal government to protect the basic soil resources of the country. State planning boards, forestry and conservation associations, and other agencies are engaged, also, in the great task of reclamation and conservation of the soil. There is every reason to believe that a comprehensive program of soil conservation will be developed within a relatively short time.

THE WASTE OF LABOR

In Chapter 3, we examined in some detail the most tragic forms of labor waste, which appear in connection with the problem of unemployment.

Seasonal, Technological, Cyclical Waste of Labor.—When in certain industries, because of seasonal unemployment, the most that workers can hope for is jobs during two-thirds of the year; when, because of technological unemployment, thousands are permanently laid off from occupations for which they have prepared by long training, and in which they had expected to find a lifetime of remunerative work; and when, as from 1930 to 1938, millions of able and willing members of our so-called labor army plead for work and get only a dole—there is no denying that our economic order is wasteful of labor.

The waste of labor is particularly costly. For labor that is not used when it is available is gone forever, like the unused water-power resources to which we referred earlier in the chapter. Moreover, the human beings whose labor is spurned must in any event be given maintenance, however inadequate it may be; and this subsistence charge constitutes a running expense for which society gets no return whatsoever in the form of economic goods. There is also, of course, an incalculable cost in the destruction of

[9] Maury Maverick in *New Republic,* November 25, 1936.

human values. For one of the sorriest consequences of unemployment is the broken morale suffered by men who, through long-continued, enforced idleness, are finally driven to the conclusion that they are of no account in our economic life, since there is nothing they can do that the world wants done. Though these "human costs" are not measurable in dollars and cents, they are none the less a social burden, even in the strictly economic sense; for the continually unemployed become eventually *unemployable*, they consume at the public expense at least a little though they produce nothing, and thus they are a perpetual drag upon society.

Undermanned and Overmanned Industries.—A recent study by the Brookings Institution undertook to "measure the productive capacity of such labor as was at hand [in the United States in 1929] but was used to an amount less than it would have been able and willing to render if a larger demand had been forthcoming from the labor market. In a word [this study sought] to measure the 'practically attainable' capacity of the national labor force which we had" at that time.[10]

This survey disclosed the fact that much labor is going to waste in this country, because some of our important industries are undermanned while others are overmanned. For example, to utilize fully the plant capacity in the field of mining, it is estimated that 70,000 more workers would have been required in the prosperous days of 1929. And to operate to capacity all of our manufacturing establishments, we should have had to add to American industrial payrolls 1,000,000 more workers than they then employed. Hence, these industries were undermanned, in the sense that they had either too few workers or too much plant. If society needed the products that these industries were *capable* of turning out, then obviously the plants were undermanned; if society could not have used these products advantageously (which is scarcely thinkable, as we shall point out later) the industries in question were guilty of wasting capital—a form of waste which we shall discuss in another section of the present chapter.

But waste of labor through overmanning is practiced quite as extensively as waste through undermanning. The Brookings investigators estimated that "actual agricultural production did not utilize the labor which remained nominally attached to that industry at anything like full practical capacity," and that 500,000 agri-

[10] Edwin G. Nourse and associates, *America's Capacity to Produce*, Washington, Brookings Institution, 1934, chap. 19.

cultural workers could be spared from our farms without causing a labor shortage.[11] Other estimates of overmanning, as of 1929, included 20,000 excess workers in forestry and fishing, 270,000 in the construction industry, 10,000 in transportation and communication, and 290,000 in public, domestic, personal, and professional service. These are people who, in the words of Gilbert and Sullivan, "never would be missed" if they were to leave the industries to which they have nominally been attached. They are people who are not needed in these industries, whose presence does not increase production, and whose retention is therefore in the nature of waste of labor. This labor should, of course, be released from these several industries, and applied in lines of economic activity where it can be utilized to advantage.

Waste of Labor "on the Job."—The possibility of releasing these thousands of workers, so that they might make themselves genuinely useful elsewhere, is dependent upon the better utilization of the labor of those who remain to "carry on." In many instances, the so-called excess laborers can be spared only if those who are left on the job are employed more efficiently, through better training, better management, and better working conditions.

Much of the progress that has been made in recent years through the introduction of scientific management has resulted from providing working conditions that have enabled the workers to do their best. The adjustment of seats and work benches to meet the needs of individual workers, modifications in lighting to remove eyestrain, proper attention to temperature and humidity—these are examples of improvements in physical equipment that have been known to increase the efficiency of labor greatly. There is, for example, the case of a change in temperature from 73 to 68 degrees Fahrenheit which brought an increase of 63 per cent in the output of typists working in the office in which the change was made.

Economy in the use of labor demands that a worker's native talent shall be developed to its fullest, that the worker shall be given the highest type of work that he is capable of doing and that type only, that he shall not be allowed to sit around waiting for materials which should be on hand, that he shall be protected against preventable illness and accidents, and so on. When these and other fundamentals of economy in the use of labor are not practiced, society loses because it fails to get from its labor force as much production as it might have. There is the further fact that

[11] *Ibid*, p. 410.

workers must be fairly well contented if they are to give their best efforts to production, as regards both quantity and quality. Realizing the dangers of having dissatisfied employees, some progressive business concerns have established personnel departments, or at least hired a personnel director, whose job it is to promote good feeling, lessen friction, and look after the well-being of the workers as well as the interests of the employer. But it must be said that the vast majority of business establishments in this country are still being conducted largely on an unscientific basis. As scientific management and personnel administration are able to show concrete results, and as their advantages become more generally recognized, they may be expected to make headway and achieve a wider adoption. In the meantime, inefficient management and real or imaginary grievances between employers and employees will continue to be a common source of waste of labor.

Waste in Youthful and Aged Labor.—In 1930, more than 2,000,000 of the gainfully occupied in the United States were boys and girls ranging from 10 to 17 years of age; and more than 2,000,000 others were men and women 65 years of age or older.[12] It might appear, at first thought, that the use of the youthful and aged in industry means a very complete utilization of our labor supply, and consequent social economies. But the seeming benefits of using very young and very old workers are illusory. The error arises, as Professor Hobson points out, "from a short-sighted view of the interests of the single person or his single family, instead of a far-sighted view of the welfare of the community. It is often a source of immediate gain to a working-class family to put the children out to wage-earning as early as possible, and to keep old people working as long as they can get work to do. It does not pay the nation, even in the economic sense, that either of these things should be done."[13]

Waste in the use of child labor consists partly of the physical and moral costs that result from subjecting young people to long-continued labor, mostly of a monotonous nature, in environmental conditions which are not always wholesome. It consists, also, in

[12] *Statistical Abstract of the United States, 1937,* p 53. It seems reasonable to suppose that the Fair Labor Standards Act of 1938, by prohibiting the employment of children under sixteen in the manufacture of goods entering into interstate commerce, will bring about a substantial reduction in child labor in the United States.

[13] J. A. Hobson, *Work and Wealth,* London, George Allen & Unwin, Ltd., rev. ed., 1933, p 80.

large part, of the lessened opportunities which will be theirs because they spend some years in earning which should be given over to self-development. And it must be remembered that society as a whole loses whenever its members fail to develop their abilities fully. Society loses the larger product which it might have had, and in some instances has to support in old age those whose life earnings would have made them self-supporting had their early training not been so limited. From both the individual and the social points of view, the early years of life are spent best when they are devoted to forms of development which will prepare the individual for greater productivity and enjoyment of life in his mature years.

Of labor in old age, we may say that, in general, it is neither humane nor economically wise to keep people of advanced years steadily at work. Work that is easy for those in middle life may be excessively hard on the aged, and, as was shown in Chapter 4, the old workers in a plant are often a drag upon production. It seems especially silly to allow our time-worn, industrial veterans to remain on the job, while able and more vigorous workers walk the streets in search of employment. Yet this is precisely the situation which prevails regularly in American industry. For we have, even in our most prosperous years, an army of unemployed numbering at least a million would-be workers, and at the same time keep on the job large numbers of those who have seen long service and might well be honorably retired. Of course, such retirement would involve the necessity of providing adequately for these venerable soldiers of industry, as we saw in our treatment of economic insecurity. The point to be emphasized in connection with this brief survey of waste in labor is that we shall not be using our labor to the best advantage, so long as we keep the very young and very old members of society employed and allow the able-bodied, willing, middle-aged to go without jobs.

THE WASTE OF CAPITAL

The factory buildings, machinery, tools, and other equipment which the economist calls capital are of the utmost importance to society, in that they contribute *indirectly* to the satisfaction of human wants. But since they are not capable of yielding human satisfactions *directly*, they have social usefulness only to the extent to which they are utilized in the production of consumers' goods. Capital which is not used at all, or is used inefficiently, or

is used unnecessarily, is capital wasted in whole or in part. It is not difficult to show that we have in the United States much capital of these kinds.

The Problem of Unused Capital.—When a plant fails to turn out as large a product as it is equipped to produce, it is wasting capital since the whole or a part of its equipment is idle. Such a condition is referred to by economists as "overcapacity," "excess capacity," or "unused capacity."

A number of estimates have been made of the unused capacity of various American industries. A committee of qualified engineers reported, in 1921: "Clothing factories are built 45 per cent larger than is necessary; printing establishments are from 50 per cent to 150 per cent overequipped; the shoe industry has a capacity of 1,750,000 pairs of shoes a day, and produces little more than half that number."[14] Mr. Stuart Chase in 1926 quoted estimates to the effect that there was overcapacity amounting to 20 per cent in blast furnaces, 70 per cent in steel plants, 50 per cent in copper smelters, 75 per cent in lumber mills, and 50 per cent in sugar refineries.[15] To bring the story more nearly up to date, we may cite the report of the Brookings Institution giving figures for 1929, our latest year of great prosperity, and estimating an excess productive capacity in twenty-seven selected manufacturing industries, which ranged from a low of 2 per cent in the manufacture of dairy products to a high of 55 per cent in locomotive manufacture. The Brookings conclusion for manufacturing as a whole was that 17 per cent of the equipment was unutilized in 1929—the figure being 20 per cent for the five-year period from 1925 to 1929, inclusive.[16]

Some Causes of Excess Capacity.—Excess capacity, with its inevitable waste of capital, results at times from the seasonal nature of an industry. The clothing industry, for example, must be prepared to produce as much output as the market will absorb when the demand for clothing is at its height; and this means an equipment in excess of that needed at other seasons of the year. Sometimes the cause is to be found in the mushroom growth of an industry, as in the manufacture of radio receiving sets in the 1920's. In this case, once the initial demand for radio sets had been met and the novelty of radio had worn off, it was found that the

[14] Federated American Engineering Societies, *Waste in Industry*, New York, McGraw-Hill Book Company, Inc., 1921, pp. 17, 18.

[15] Stuart Chase, *The Tragedy of Waste*, pp. 186, 187.

[16] Edwin G. Nourse and associates, *America's Capacity to Produce*, p. 307.

capital that had been put into the industry was far greater than was needed to provide sets for first purchasers and for replacement of worn-out instruments. In like manner, the great popularity of silk goods in recent years led to the multiplication of looms and other equipment for making silk, with the result that many silk mills are today excessively large and the number of mills is far too great for present requirements of the trade.

The production and sale of petroleum products afford an excellent illustration of overcapacity in several branches of a single industry. We have already spoken of the inexcusably large investment in drilling and pumping equipment. In some oil regions, largely because of the unduly rapid exploitation of the fields, the extension of pipe lines proceeded apace, and now, with the diminished production in these partially exhausted areas, the transportation facilities represent a very large percentage of overcapacity. According to the Brookings Institution, only about 80 per cent of the equipment of our oil refineries was being used from 1925 to 1929. Finally, the unwarranted multiplication of automobile service stations is apparent to all who use our highways. It is estimated that the needs of automobilists and users of other motor vehicles could be met adequately with one-third the present number of filling stations, and that the unused capacity in this single item means an overinvestment of upwards of a billion dollars.

We must not overlook the fact that waste may result from capital being misused quite as well as from its not being used at all. The reports of investigators seem to show conclusively that much of our industrial equipment that sees daily service is utilized so inefficiently that a smaller quantity properly employed would be equally productive. Obviously, capital that is badly used is partly wasted. There is much waste, also, through the failure of business men to replace antiquated capital with that of the most improved types. On this point we shall have more to say in the next section.

The Responsibility for Waste

It is an easier matter to describe waste in production than to allocate fairly the responsibility for such waste. However, it is safe to say that some of the waste in our economic life is chargeable to the enterprisers and workers who carry on our productive processes, some is chargeable to the whims of consumers, and some to the nature of our economic system itself.

The Wastefulness of Employers and Employees.—The report of the Federated American Engineering Societies, to which we have referred, undertook to place the blame for waste in six important fields of production. The division of responsibility for waste in industry, as arrived at by these investigators, is shown in Table 19. "Over 50 per cent of the responsibility for these wastes," reads the report, "can be placed at the door of management and

TABLE 19.—RESPONSIBILITY FOR WASTE IN PRODUCTION IN SELECTED INDUSTRIES[a]

Industry Studied	Responsibility Assayed Against Management (Per Cent)	Responsibility Assayed Against Labor (Per Cent)	Responsibility Assayed Against Outside Contacts (the Public, Trade Relationships, and other Factors) (Per Cent)
Men's clothing mfg....	75	16	9
Building industry.....	65	21	14
Printing.......	63	28	9
Boot and shoe mfg. ...	73	11	16
Metal trades.........	81	9	10
Textile mfg.........	50	10	40

[a] Source: Federated American Engineering Societies.

less than 25 per cent at the door of labor, while the amount chargeable to outside contacts is least of all."[17] This conclusion has done much to dispel the once prevalent notion that business men are generally efficient and workers inefficient, and that employers strive always to keep production up and costs down while employees usually do only as much work as they must to hold their jobs.

"Management, the unseen force which drives all that is physical within a factory, is by far the most important factor of the present industrial age," writes an authority on scientific production.[18] "Machinery and materials may be put to work, workers may labor; but without adequate management to organize and consolidate them into a profitable, co-ordinate whole, to distribute the results of their work effectively, and to govern their operations during performance, this performance may become so uneconomic

[17] *Waste in Industry*, p. 9.

[18] Richard H. Lansburgh, *Industrial Management*, New York, John Wiley & Sons, Inc., 1928, p. 1.

as to cease entirely." Since management decides in present-day industry what is to be done, and when, and how, it is not surprising that management, rather than labor, is usually at fault when a plant fails to live up to its productive possibilities.

The investigators for the Federated American Engineering Societies listed the chief causes of industrial waste under four headings, as below:

1. Low production caused by faulty management of materials, plants, equipment, and men.
2. Interrupted production, caused by idle men, idle materials, idle plants, idle equipment.
3. Restricted production intentionally caused by owners, management, or labor.
4. Lost production caused by ill health, physical defects, and industrial accidents.[19]

They found, further, that the heavy toll of waste resulted largely from the failure of many establishments to meet the high standards of the best-managed plants in the several industries that were studied. In the metal trades, for example, four and one-half times as much waste was discovered in the *average* plants as in the *best.* The ratio in boot and shoe manufacture was three to one; in printing and men's clothing manufacture, two to one; and in textile manufacture and the building industry, one and one-half to one.[20]

A later study conducted by two prominent mechanical engineers, Messrs. L. P. Alford and J. E. Hannum, estimates that if the performances of all plants were raised to the level of the best, the quantity of output would be increased 55 per cent in blast furnace operation, 73 per cent in the lumber and timber products industry, 81 per cent in machine tool manufacture, and 97 per cent in petroleum refining.[21] Yet another estimate is that of forty-five engineers and twenty-six executives in some thirty branches of production, reported by the Columbia University Commission on Economic Reconstruction in 1934. This group estimated that production in their several industries could be raised, on the average, some 85 or 90 per cent, if the best current standards of production were adopted throughout these industries; and twenty-seven engineers of the group estimated that the output of *all industries* could

[19] *Waste in Industry,* p. 8.

[20] *Ibid.,* p 10.

[21] Columbia University Commission, *Economic Reconstruction,* New York, Columbia University Press, 1934, p. 89.

be increased 75 per cent "with equipment and management brought to the level of best current practice."[22]

The greater responsibility of management does not justify us in withholding criticism from workers whose attitudes and actions lead to waste in production. As is shown in Table 19, there are workers of this kind in industry; and in Chapter 2 we saw that there is sometimes a limitation of output through labor's opposition to the introduction of new machinery and the practice of "soldiering on the job." There is ample reason, then, for the Federated American Engineering Societies' statement, "It must be recognized that if management is to meet this responsibility fully it must have the cooperation of labor."[23] Waste in the conduct of business can be reduced to a minimum only through the joint efforts of employers and employees.

Waste Caused by Consumers.—The rôle played by consumers in the tragedy of waste in production is an important one. Though enterprisers seem sometimes to produce goods and then force them upon the buying public by methods of "high-pressure salesmanship," the fact remains that to a very large extent the consumer directs production. It is he who in the main decides what goods shall be produced, and when and in what quantities they shall be made available. And his decisions are often the cause of waste in production.

In the following chapter we shall deal at some length with certain important problems in the field of consumption. We shall raise there the question of whether it is socially desirable that luxuries should be produced while there is a dearth of certain necessities. But this is a question that relates to waste in consumption rather than waste in production. However, when millions of people insist upon purchasing much of their personal habiliment just in time for the "Easter parade," and when they buy twice as many automobiles in some months as in others, they are adding to the problem of waste in production. For they make highly seasonal some types of production which might be spread fairly evenly over the year, and thus they contribute to waste of capital and labor, as we have seen. And when in hot haste they abandon the drama and vaudeville for motion pictures, and the piano and phonograph for the radio, they render distressing and expensive a transition

[22] *Ibid.*, p. 92.
[23] *Waste in Industry*, p. 9.

in consumer demand which might have been relatively painless and economical if only it had been effected more slowly.

In the present chapter we do not ask whether the "right" goods are being produced, but only whether what is produced is being produced efficiently. But it may not be amiss to suggest that if consumers made less of a fetish of fashion, and took more seriously Pope's couplet,

> Be not the first by which the new are tried
> Nor yet the last to lay the old aside,

they could have the goods they now enjoy—and at lower prices, because their moderation (by lessening seasonal and technological disturbances) would aid in reducing the wastes of production, hence the costs of production, and finally the selling prices of the goods.

The Wastes of *Laissez Faire*.—In an earlier paragraph we hinted that an economic system such as ours might itself be responsible for waste in production. *Self-interest* and *free enterprise* may provide the incentive and opportunity that stimulate production, as is often suggested, but they may also lead to the waste of land, labor, and capital, as we have shown by numerous illustrations. The institution of *private property* may in general be a great aid to production, but it may also impede production by permitting a factory owner to close his doors whenever he cannot operate his plant with personal profit. *Competition* may perform the beneficent function of regulating price, holding it fairly close to costs of production; but "cutthroat competition" may drive an enterpriser into bankruptcy, and his employees and equipment into at least temporary idleness. *Large-scale production* may effect large economies, but it may conceivably grow into monopoly and result in the limitation of output. *Specialization* may increase the productivity of individuals and industries, but it may also lead to vested rights which (in the form of a tariff or subsidy) will burden a people for generations.

A *laissez-faire* economy is one in which there is abundant freedom of economic action. This means, in practice, that many enterprisers in many lines are going their individual ways, each estimating, as best he may, the probable total demand for his product, the probable output of other enterprisers in the same line, and a dozen other important items about which he necessarily has but meager information. The result is many mistakes, the production

of too much of this and too little of that, recurrent business depressions, and a heavy toll of waste.

It is difficult to see how waste in production could be prevented without careful, centralized planning of output in all important lines of economic life. But such planning would put an end to free enterprise, as we have known it. Whether the gain would be greater than the loss is an open question which will have attention in our discussion of recent radical movements in foreign countries. We have sought here merely to indicate that some waste in production appears to be an inevitable feature of the American economic system of today.

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1. What evidence is there that tends to show that American business enterprises are conducted efficiently?
2. Define "waste in production."
3. What, according to Professor Hobson, is "illth"?
4. "The enterpriser who gets the maximum of output from the land, labor, and capital he employs, is not guilty of waste in production, even though the goods he makes are in the nature of 'illth.'" Explain.
5. "There are instances in which productive methods, though socially wasteful, may be individually profitable." Explain.
6. Why should it be difficult to secure exact and accurate figures on the amount of waste in a given industry? Illustrate.
7. How do you account for the large amount of waste in coal mining and petroleum production?
8. Contrast the amount of waste in the utilization of coal with that in the refining of petroleum.
9. Why should a society regret particularly the failure to develop fully its available natural water-power resources?
10. There is no need to regard as hopeless the situation which has resulted from the misuse of our forest and farming land. Explain.
11. Explain the connection between unemployment and waste in production.
12. Some of the "costs" of waste of labor are not measurable in monetary terms. Explain.
13. Discuss the problem of waste as it arises from industries being "undermanned" or "overmanned."
14. Labor may be wasted, even when workers are kept steadily on the job. Illustrate.
15. "It does not pay the nation, even in the economic sense," "to put the children out to wage-earning as early as possible, and to keep

old people working as long as they can get work to do," says Professor Hobson. Why not?

16. What is the meaning of "excess capacity"? Give at least two synonyms for this term.
17. Describe conditions which give rise to excess capacity.
18. Summarize the findings of the Federated American Engineering Societies as to responsibility for waste in production.
19. Consumers are sometimes blamed for causing waste in production. In what ways might they be responsible?
20. "Some waste in production appears to be an inevitable feature of the American economic system of today." Explain.

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15 WASTE IN CONSUMPTION

CONSUMPTION IS THE GOAL OF PRODUCTION—MAN MAKES GOODS IN ORDER TO HAVE THEM AVAILABLE FOR USE IN THE SATISFACTION of his many wants. And since consumption is the goal of production, it follows that production comes closest to realizing its full possibilities when *real income*, which consists of commodities and services, is so constituted and so distributed as to result in the individual and social maximization of utility.

Individual and Social Maximization of Utility.—An individual attains the maximization of utility, or satisfaction, in the expenditure of his *money income* when he buys with it the commodities and services which yield him a larger amount of utility than would be yielded by any other assortment of economic goods that he might buy with this amount of money. Any individual who fails to maximize the utility that might be his is, economically speaking, doing less well than he might do. So, also, is the society that fails to distribute its income among its members in such a way as to attain the maximization of utility. For if it is good economics for an individual to seek the maximum of satisfaction in consumption, it should be equally sound practice for a society.

Just as the individual maximization of utility requires that no portion of a person's money income shall be spent for any economic good if greater individual utility could be had by spending it for something else, so, in like manner, the social maximization of utility would demand that, in the distribution of society's money income, no dollar should go to any person if greater social utility would be had through its going to another. With the money income so distributed, and with the members of society striving earnestly to maximize the utility obtainable from the expenditure of the individual incomes then in hand, the available land, labor, capital, and business enterprise would naturally gravitate to the points where they were most needed. Thus, these agents of production would be allocated among the various industries in such a way as to bring forth those commodities and services which,

when purchased by individuals with their money incomes, would lead to the maximization of utility for society as a whole.

The Nature of Waste in Consumption.—If the principle of social maximization is sound, and if its acceptance leads inevitably, as we believe it does, to the conclusion stated above, it should be clear that any failure on the part of society to achieve the maximization of utility must be regarded as waste in consumption. We may define waste in consumption, then, as *any disutility experienced by society through the consumption of harmful commodities or services, or any loss of utility suffered through the inefficient use of consumers' goods.* Our task in the present chapter is to look about for evidences of consumption which, according to this definition, is wasteful, and then to inquire into the possibilities of reducing or eliminating consumption of this kind.

Disutility in Consumption

The Meaning of "Illth."—Since consumers' goods come under the general heading of wealth, we should expect all consumers' goods to contribute to the well-being of those who use them. But some economic goods seem more likely to injure than to benefit the consumers. Ruskin was so strongly impressed with this fact that he coined the word "illth"—later popularized by Professor Hobson, as we have already noted—and applied it to goods which he thought, because their use was likely to have ill effects upon society, should not be produced.

Illth is, of course, the very antithesis of wealth, since its consumption brings disutility instead of utility. Professor Hobson, following Ruskin's lead, says in this connection that "everyone will admit that many sorts of marketable goods and services are injurious alike to the individuals who consume them and to society. A large proportion of the stimulants and drugs which absorb a growing share of income in many civilized communities, bad literature, art and recreations, and the services of prostitutes and flunkeys, are conspicuous instances."[1] But the "many sorts" of goods that are referred to in this quotation are not so easy to locate in the market place. Indeed, it is something of a task to enlarge the list of "conspicuous instances" drawn up by Professor

[1] J. A. Hobson, *Work and Wealth,* pp. 106, 107. Our many citations of *Work and Wealth* in the present chapter are attributable to the fact that Professor Hobson is the outstanding "welfare economist" of the day, and his ideas are most fully set forth in that work.

Hobson, and even some of these items might not be regarded by everyone as illth. What, for example, is "bad literature"? Would it include every book condemned by the late Anthony Comstock (the crusader against obscenity who sought for years to "purify" the reading matter of the American people)—even a work that was hailed by recognized critics as great literature? And would an attempt to abolish bad literature permit to go unchallenged those sugar-coated novels which, however innocuous they may be from the point of view of morals, are weakly constructed and slovenly written, and fail utterly "to hold, as 'twere, the mirror up to Nature"?

The Scarcity of Illth.—A division of consumers' goods into "wealth" and "illth" assumes the existence of an agency that is competent to pass upon such matters, and one, moreover, whose decisions would meet with the approval of the general public. But it seems to us that such a division is scarcely necessary—that a far better plan is to grant freedom of choice to consumers, keeping them informed, however, of the dangers of any goods that are likely to prove harmful to purchasers. Few kinds of consumers' goods that are offered for sale today are so certain to bring disutility, and so clearly incapable of giving utility, that by common consent they could be designated "illth." There are exceptions, to be sure. Perhaps the best examples are to be found among the so-called patent medicines and in the field of adulterated commodities. Few intelligent people would argue that a "cancer cure composed of water diluted with impure alcohol"[2] could have any curative value, or deny that it might do positive harm by delaying the application of scientific methods of treatment; and few would question that raw milk preserved with liberal quantities of formaldehyde might easily yield more disutility than utility. In instances such as these, there would seem to be ample grounds for outlawing the goods in the interests of the public health.

Disutility from Misuse or Excess Use of Goods.—But when all is said and done, there are relatively few clear-cut cases of consumers' goods that could not conceivably yield utility. Such examples as may be cited result from our practice of producing for profit rather than for use, and these goods find a sale only because of the ignorance of the purchasers. If we were to include among items of illth those goods which have utility-yielding possibilities but are often used in harmful ways, the number would

[2] Cited in Stuart Chase, *The Tragedy of Waste,* p. 64.

be substantially increased. Cocaine may be used beneficially for the relief of pain, or consumed destructively in developing or satisfying the drug habit. Alcohol unquestionably has its legitimate uses, but its abuse sometimes leads to drunkenness and degradation. A pistol may have social utility when carried by a policeman, but social disutility in the hands of a gangster. Finally, to cite an example of a common misuse of a consumers' good, an excess of heat in a dwelling means the consumption of more fuel than should be burned, and, at the same time and as a direct consequence of this waste in consumption, a probable increase in nose and throat ailments among those who occupy this overheated house. This sort of illustration might easily be multiplied many times, so likely is the excessive use of a consumers' good to result in disutility rather than utility.

It would seem, then, that positive disutility in consumption is more likely to result from the misuse or excess use of goods than from the consumption of goods which do not have any legitimate uses. We believe it is imperative to prohibit the production of so-called consumers' goods which seem certain to injure those who use them, and to regulate strictly—as is now sometimes done—the sale of firearms, habit-forming drugs, and other commodities and services which, if purchased by irresponsible persons, may lead to extensive or irreparable damage. But since most good things are capable of being turned to bad uses, prohibition and regulation cannot provide a complete solution of the problem. The remedy seems to lie, rather, in launching a program which will enable consumers to exercise genuinely intelligent choice in spending their money incomes. We shall deal with this matter more specifically in a later section of the chapter.

Economic Inequality and Waste in Consumption

Waste in consumption is closely related to economic inequality[3]—so closely, indeed, that it seems highly unlikely that we shall ever achieve anything even approximating the social maximization of utility in consumption without bringing about, also, something in the way of an equalization of incomes. Certainly, the maximization of utility would be wholly impossible in the face of the great economic inequalities which exist today.

The explanation of this statement is tied up with the principle of diminishing utility. According to this principle, the utility of a

[3] This relationship is dealt with again in chap. 16.

dollar is smaller to a man of great wealth than to a poor man. The loss of a dollar would mean little or nothing to Mr. Rockefeller, but to a day laborer it might mean cutting down on the purchase of food for his family. The principle is one which not only exists in academic circles, but is also in good and regular standing in the world of practical affairs. It is, of course, the theory upon which most civilized nations have built their systems of taxation. For modern taxes are, in general, based upon ability to pay, as we noted in our treatment of taxation in Chapter 8.

Diminishing Utility and Progressive Taxation.—A married wage earner in the United States is not required to pay any federal income tax on the first $2500 of his income, on the theory that up to that point the utility of every dollar is sufficiently great to warrant exemption. But a sharply progressive surtax is imposed upon all net surtax incomes of $4000 and over, reaching the maximum rate of 75 per cent on that portion of any income which exceeds five million dollars. The implication is perfectly clear. We have accepted the principle that the rich should make larger contributions to public expenditures than the poor, not only absolutely but also relatively, because a dollar means less to the rich than to the poor.

Current Inroads upon Large Incomes.—It might be argued that the acceptance of the principle of progression for the purpose of minimizing sacrifice in the payment of taxes does not necessarily lead to an advocacy of equal (or approximately equal) incomes in the interests of maximizing utility in consumption. And yet these two ideas have much in common, and their differences seem to be those of degree rather than kind. Both are based upon the principle of diminishing utility. And though progressive taxation, as practiced today, does not take so much of our rich men's annual receipts as to bring about an approximate equalization of incomes available for individual spending, it goes in many instances much further than is generally realized.

The present federal income surtax in the United States takes 30 per cent of a $100,000 income, 57.2 per cent of a $500,000 income, 64.1 per cent of a million-dollar income, and 71.82 per cent of a five-million-dollar income. Though the absolute amounts that these income-getters are permitted to retain are still very large, there is no denying that present-day progressive taxation imposes considerable restrictions upon the exercise of property rights in income. We do not limit the amount of income a man

may *receive*, but we sometimes limit radically the amount he may *keep*. It seems fair to say that the principle of progression in taxation now has general acceptance, and that it could be used, if society deemed it desirable, to bring about a virtual equalization of incomes.

Trends Toward Social Maximization of Utility.—Furthermore, the revenue derived from taxation is not being employed nowadays merely for carrying on what we ordinarily think of as the "affairs of government." Rather, it is being used increasingly to provide for human needs which we used to expect every man to look after for himself. When billions are collected from taxpayers and spent for the relief of the unemployed, as in the post-1929 depression, the process is one of taking from those who have and giving to those who have not. It is, in effect, a procedure through which society, at one and the same time, moves in the direction of the equalization of incomes and the maximization of utility. To be sure, the movement is not a particularly speedy one, but the trend is unmistakable. We are not suggesting that society is consciously attempting to achieve the equalization of incomes or the maximization of utility, but simply that neither of these propositions is so foreign to our present economic order as it might appear, at first sight, to be.

Conspicuous Consumption and Waste.—A serious disadvantage resulting from great inequalities in incomes is the tendency, on the part of the very wealthy, to spend extravagantly for the sake of winning the admiration of those unable to buy on so lavish a scale. This subject is discussed elsewhere in the present volume,[4] but is introduced briefly at this point because of its obvious relationship to waste in consumption.

Nassau William Senior, a noted nineteenth-century economist, wrote many years ago about "the desire for distinction—a feeling which if we consider its universality, and its constancy, that it affects all men and at all times, that it comes with us from the cradle and never leaves us till we go into the grave, may be pronounced to be the most powerful of human passions." Since this desire for distinction commonly takes the form of competitive expenditure, it needs no argument to show that waste in consumption is bound to accompany great differences in spending ability. Among modern examples of conspicuous consumption are the $3,000,000 private home built for a well-known industrialist,

[4] See chap 16.

the two hundred servants employed in the home of a prominent financier, the fifty-one passenger cars belonging to the several members of a Philadelphia family, and—on a somewhat smaller scale, but none the less interesting—the mink coat worn by All-American Biff, a bull terrier, "tailored for him by one of Chicago's leading furriers and given to him for a Christmas present last year" by his owner.[5] It is expenditures such as these that lead us to observe, in the next chapter, that "the elimination of both individual and social waste in consumption can be attained, if at all, only in a society in which incomes are substantially equal."

The very wealthy may properly be charged with much of the waste resulting from conspicuous consumption, because their large expenditures constitute a formidable part of the total waste of this kind, but there are many in the lower-income groups who must also accept a share of the blame. For just as

> Great fleas have little fleas upon their backs to bite 'em,
> And little fleas have lesser fleas, and so *ad infinitum,*

so, too, is there a hierarchy in the realm of conspicuous spenders. "Keeping up with the Joneses" appears to be no less popular among middle-class income-getters than among the multimillionaires; and the practice of living beyond one's means—which is a perfectly natural outgrowth of an unwillingness to be outshone in spending—is so common that it no longer excites comment.

Since few are wholly guiltless of spending for display, it may seem somewhat unfair to single out the very rich and charge them with special culpability. But conspicuous consumption is a social ill that originates among the economically great, and works its way down to the rank and file. Since the very wealthy set the pace that others try to follow, they must be prepared to accept a particularly large portion of responsibility for the waste in consumption that results from this lavish expenditure. It may be true, as Nassau Senior says, that the desire for distinction is the most powerful of human passions; but that is no reason why society should permit it to take the form of competitive spending, when spending of this sort must inevitably interfere with the attainment of the social maximization of utility in consumption.

[5] *New Republic,* January 13, 1937. The article cites the case of another lucky dog, Pico, owned by Edgar Allan Woolf, a motion-picture writer. "Noticing that Pico seemed to suffer from the heat, Woolf called in a refrigeration engineer and had the dog-house air-conditioned."

Individual Maximization of Utility in Consumption

We feel that our discussion of consumption thus far should have convinced the reader that the social maximization of utility cannot be achieved while we have great inequalities in individual incomes. But even if we had an equalization of incomes, there could be no social maximization unless we managed in some way to bring about individual maximization of utility in consumption. Utility is an essentially personal thing, and two individuals with equal money incomes might have to spend in widely different ways in order for each to get the most out of his income. Even in the presence of great inequalities in incomes, such as exist today, much would be gained if we could achieve the individual maximization of utility in consumption; and every advance of this kind would be a step in the direction of social maximization of utility. Anything that is done in the way of increasing individual utility in spending a given money income is a net gain; it not only helps the individual himself, but it also helps to bring society a little closer to the goal of the social maximization of utility in consumption. We may now examine some specific causes of the consumer's failure to get the maximum of utility from the expenditure of his money income.

Waste Through Carelessness in Purchase and Use.—Success in making one's money income go as far as possible in providing for one's wants depends upon the exercise of great care in the purchase of commodities and services. It is wasteful to spend a dollar—or a dime—for one thing if its expenditure for something else would result in greater utility. This very simple point seems often to be quite overlooked. Many people—and sometimes those who can least afford it—appear to do much of their buying impulsively rather than deliberately. The sight of a chic hat in a shop window, or a gay cravat in a men's furnishing store, drives into limbo all thought of more urgent needs, and the thing is bought on the spur of the moment.

Another source of waste in consumption is the tendency of many people to buy without making a comparison of prices, either as between equally satisfactory brands which sell at different prices, or between competing dealers' different prices for the same commodity. The failure to buy at recurrent "special sales" such nonperishable goods as soap, paper towels, and canned fruits and vegetables, often leads to paying 15 to 25 per cent more for these

commodities than would be necessary if a little care and foresight were exercised in shopping for staple articles, many of which (being nationally advertised under copyrighted names) are clearly the same no matter from whom they are bought, or at what price. Many people, too, are likely to assume that high price necessarily means high quality, on the theory that "you get just about what you pay for." But goods are sometimes sold on the basis of "class price," with prices adjusted to the paying capacity of the customer for commodities that are unquestionably the same. Even harder on the notion that high prices mean high quality was a series of laboratory tests made on ten prominent brands of vacuum cleaners several years ago; for the tests showed that the highest-priced cleaner in the lot was the one that gave the poorest performance! Obviously, price is not always a measure of quality.

Chargeable to carelessness, also, is the failure of consumers to get the maximum of utility out of goods once they have purchased them. An examination of the contents of American garbage cans during the World War revealed the fact that large quantities of edible bread and meat were being thrown away. In the matter of converting odds and ends of food into wholesome, savory dishes, American housewives might learn much from the women of France and Germany, and thus save some millions of dollars a year with no loss in utility. The readiness with which many people discard clothing which is still entirely presentable, radio sets which are capable of giving excellent reception, and automobiles which are practically as serviceable as the latest models, is responsible for much loss of utility in consumption. Clothing and automobiles must not be expected to last forever; but if a suit of clothes is thrown away or a car "turned in" before it has given its owner the maximum of *acceptable service,* it would seem that this is waste in consumption. And unless the owner has carefully weighed the pros and cons of the situation (which is all too seldom the case), the waste may well be charged to carelessness in the use of consumers' goods. Often, of course, the retirement of an old good in favor of a new one is in the nature of conspicuous consumption.

Conspicuous Consumption Once More.—Conspicuous consumption is responsible not only for social waste in consumption, but also, in all probability, for much of the failure of individuals to maximize the utility purchasable with their money incomes. There is a genuine satisfaction that comes from the consumption

of a commodity or service which adds to one's physical, mental, or social well-being. Doubtless, also, there is satisfaction of a sort to be had from outdoing another in spending for the sake of display—else it would scarcely be so widely practiced. But it may well be questioned whether this is not, after all, a spurious kind of satisfaction, and recognized as such by the conspicuous consumer himself in his saner moments. For all save the very wealthy, of course, every lapse into conspicuous spending reduces the amount of money income available for expenditures of other kinds. And it would seem to follow that, for most people at least, indulgence in conspicuous spending must render impossible the attainment of individual maximization of utility in consumption.

Waste Through the Ignorance of Consumers.—Professor Carver, in undertaking to prove that capitalism is preferable to socialism, argues that people as a rule buy more intelligently than they vote.[6] However that may be, the truth is that most people do not buy very intelligently. In some instances, as we noted in an earlier section, the fault is one of carelessness—a failure to apply to the spending of one's money income the information which one has or might readily get. In many cases, however, the purchaser is not to blame for his inability to judge the relative merits of consumers' goods. Doubtless the average man is more expert as producer than as consumer. He is a specialist in production, having devoted his time and energy to mastering a single trade or task, while as a consumer—or a buyer—he ventures into a hundred fields, in none of which can he hope to have very extensive information. The result is that in most of his buying he bargains at a distinct disadvantage, since he pits his meager knowledge against the skill and experience of the seller.

It is small wonder, then, that the consumer often fails to get the most for his money. We have already seen that price is not a safe guide to quality, nor for that matter is the appearance of a commodity to be relied upon. The piece of silk cloth that feels so strong and durable is probably weighted with sugar or lead; the oranges that appear so lusciously ripe may owe their sunny complexion to gas or dye; and the mattress that promises a lifetime of peaceful sleep may develop little hills and valleys within the year. Our ignorance of "true values" in the fields of food, clothing, cosmetics, housefurnishings, automobiles, and other consumers' goods is

[6] T. N. Carver, *Essays in Social Justice,* Cambridge, Harvard University Press, 1922, pp. 113-125.

most profound. As one writer puts it, "With no defense except a waning quality of common sense, the ultimate consumer makes his blundering way; a moth about a candle."[7]

However, the consumer is not wholly helpless, for there are several increasingly influential agencies that are working in his behalf. We are not now referring to such assistance as is rendered by the enforcement of federal and state legislation designed to discourage fraud and misrepresentation; or to such agencies as the Better Business Bureaus, which do something to tone down the extravagant claims of advertisers, and the "Good Housekeeping Institute," which tests and guarantees all articles advertised in *Good Housekeeping*, but declines to say which is the best among several competing brands. We have in mind, rather, Consumers' Research, Inc., and the Consumers Union of the United States, Inc.,[8] two non-profit organizations which undertake to provide their respective subscribers with accurate, unbiased information about many kinds of consumers' goods.

These "services" do not pretend to cover the field completely, but they are already sufficiently extensive as to be of great assistance to the average consumer, and their data are being revised and added to continually. Many of the tests which form the basis of their reports are made in the laboratories of one or other of the two organizations, though some are conducted in outside laboratories. The information comes to the subscriber in the form of *comparative* lists, which classify specific brands of a commodity as *good*, *fair*, or *poor*. It goes further and tells which is the "best buy," so that the consumer learns not only what brands to avoid, but also—and this is of the utmost importance—which particular brand will give him the most for his money. Our publicly financed United States Bureau of Standards might do much to protect the consuming public from being imposed upon, by dedicating a part of its admirable facilities to the discovery and publication of the truth about consumers' goods that are used by millions of Americans. Indeed, it would help somewhat if the Bureau did nothing more than publish the results of the tests which it now makes for

[7] Chase, Stuart, and Schlink, F. J., *Your Money's Worth*, New York, The Macmillan Company, 1927, p. 41. The woeful ignorance of consumers is dealt with at length, also, in Schlink, F. J., and Kallet, Arthur, *100,000,000 Guinea Pigs*, New York, The Macmillan Company, 1933; and Phillips, M. C., *Skin Deep*, Washington, N. J., Consumers' Research, Inc., 1934.

[8] Consumers' Research, Inc., Washington, N. J.; Consumers Union of the United States, Inc., 55 Vandam Street, New York City.

business men and corporations. So long as it fails to do either or both of these things, the consumer must continue to rely upon privately supported agencies, such as Consumers' Research and the Consumers Union, which appear to be performing a necessary social function—and performing it successfully in the face of considerable opposition from business men who find their disclosures somewhat embarrassing.

Waste Through Deceptive Advertising.—Advertising has been, and will probably continue to be, one of the chief obstacles to the individual maximization of utility in consumption. There is no question that advertising may play a socially useful rôle in the creation of possession utility. But if, at any time, advertising subtracts from the sum total of utility in society, instead of adding to it, those who are responsible are clearly guilty of waste; and if advertising leads buyers astray and prevents them from maximizing utility, it may properly be condemned on the basis of contributing to waste in consumption.

Advertising may be getting more truthful (as its advocates frequently claim) or it may not, but in any case it still has a long way to go before the consumer can safely accept it at face value. Outright falsehood may be rare, but of unwarranted implication there is enough and to spare in many advertisements. The situation is interestingly described by an advertising publisher in a speech made to advertising men. He said, in part:

> Too many of our creators of advertising, it would seem, have forsaken the mansions of logic to wander capriciously in a weird new state—a state that can be described only by the coined word "Adnesia." Only in this strange state are cigarettes viewed as an aid to health; only here do kindly professors go about counseling mothers in the delicate matter of administering laxatives.
>
> Where, except in "Adnesia," could one reasonably expect to find Romance in a package of soap chips, or detour the divorce court by the simple expedient of changing to a new brand of tooth paste? And surely only one long-resident in this crazy state could have conceived the cock-eyed notion of borrowing the testimony of dimpled and diminutive Shirley Temple to exploit a two-ton motor truck! There, indeed, is genius in its dizzy eminence.[9]

A very mild instance, but an actual one, of poetic license in the realm of advertising was revealed recently by the Federal

[9] "What Advertising Men Say About Advertising," *Special Bulletin 25*, Washington, N. J., Consumers' Research, Inc., October, 1936, p. 1.

Trade Commission. In singing the praises of its razor blades—"Made of English Razor Steel"—a New York department store announced: "We went to Pennsylvania for a new secret-process, high-speed steel. In ingots, we took it to England to be rolled to a ribbon, because the British armorers roll steel with unbeatable accuracy. We brought the ribbon-reels back from England and had them cut into blade-shapes, then honed and stropped with more loving care than we've ever seen put into such a job." In fact, these blades were stock blades made by a New Jersey corporation, and not under supervision of the department store. The Federal Trade Commission ruled "that the respondent's false representations that it oversees each step in the manufacture of these blades tends to lead a substantial part of the public to attribute to them a quality not usually attributed to merchandise made for the trade generally."[10]

Even if we accept literally the statement of an experienced advertising man that "advertising copy during the past several years has been a bunch of blah, blah, bunk,"[11] the fact remains that advertising pays. That is to say, it pays the seller—whatever the effect upon the buyer may be—for it unquestionably stimulates sales. Indeed, a recent study made by a research specialist leads to the conclusion that in some cases advertising is more important than low prices, style, or quality, in selling women's, misses', and junior misses' dresses and sports wear.

Table 20 presents the significant conclusions of this study in convenient form. It shows that in selling women's dresses advertising proved to be 116 per cent as important as low price, 127 per cent as important as style, and 124 per cent as important as quality. In disposing of junior misses' dresses, the relative importance of advertising to low price, style, and quality was shown to be, respectively, 122 per cent, 193 per cent, and 223 per cent. If these figures have any validity at all, they suggest to the self-seeking business man that it is wiser to spend on advertising than on quality. What is said about a commodity is apparently more important to the purchaser than the quality of the commodity itself. This amounts, of course, almost to an invitation to market shoddy goods by means of intriguing sales talk, rather than sound goods through accurate, straightforward description. It would be child-

[10] The case is cited in Consumers' Research *Bulletin*, Washington, N. J., Consumers' Research, Inc., March, 1937, p. 6.

[11] "What Advertising Men Say About Advertising," p. 6.

TABLE 20.—RELATIVE IMPORTANCE OF ADVERTISING AND OTHER MERCHANDISING FACTORS IN SELLING CLOTHING (IN PERCENTAGES)[a]

Commodity	Percentage Importance of Advertising to		
	Low Price	Style	Quality
Women's dresses	116	127	124
Misses' dresses	79	121	135
Junior misses' dresses	122	193	223
Sports wear	94	133	156
Average	103	143	159

[a] Source. *New York Herald Tribune*, July 21, 1936.

ish to suppose that enterprisers never take advantage of a situation of this kind, and equally so to think that individual maximization of utility in consumption can be achieved until the situation is remedied.

CONSUMERS' COOPERATION

We have sketched briefly some of the obstacles that stand in the way of the attainment of individual maximization of utility in consumption. These and other difficulties experienced by consumers have led to the conclusion that consumers' goods might be purchased more advantageously if the job were done collectively instead of individually. The outcome of this conviction has been the organization of consumers' cooperative associations. The recent spread of the cooperative movement among consumers warrants a brief discussion of the aims and methods of consumers' coöperatives.

Rochdale Society of Equitable Pioneers.—Consumers' cooperation had its beginning in Rochdale, England, in December, 1844, when twenty-eight weavers banded together into an organization through which they hoped to get more for their money than was possible when they bought as individuals from retail stores. With a total capital of about $150, the Rochdale Society of Equitable Pioneers bought a small stock of flour, oatmeal, butter, and sugar, with which they began their undertaking of squeezing out the middleman's profits, and thus increasing the utility obtainable from the spending of their wages. By the end of the year 1845, they had seventy-four members, a paid-up capital of $900, and a

record of having transacted $3500 worth of business in a twelve-months period. In 1934, this same Rochdale Society had 44,000 members, nearly $3,000,000 in capital, and did a business totaling $3,285,000. From 1844 to 1934, its total volume of business was $150,000,000, and it distributed among its members "surplus-savings" to the amount of $20,000,000.[12]

"The basic principles adopted by these famous weavers to solve their own purchasing problems were eightfold: Their consumer cooperative would sell goods at prevailing local prices; a fixed rate of interest would be paid upon capital invested; profits,[13] after payment of all expenses including interest, should be distributed in proportion to member purchases; no credit would be granted; both sexes were to have equality in membership rights; each member was to have just one vote; regular meetings of members were to be held; and accounts were to be properly kept and audited."[14]

The Goal and Method of Consumers' Cooperation.—The substantial degree of success achieved by the Rochdale Pioneers is perhaps less surprising than the fact that their fundamental principles, as originally outlined, have endured for almost a century and even today form the basis of most of the consumers' cooperatives throughout the world. According to the Cooperative League, the national federation of consumers' cooperative associations of the United States, present-day consumers' cooperation is based upon four great principles, upon which will eventually be built a Cooperative Economic Society. "Its principle of open membership will give us economic brotherhood. Its principle of 'one person, one vote' will give us economic democracy. Its principle of 'minimum interest on shares' will give us security instead of speculation. Its principle of 'distributing the surplus savings as dividends on the basis of patronage' will give us just distribution of wealth. These are the four corner stones of a Cooperative Economic Society."

From the tone of this statement, it is evident that consumers' cooperation is expected by its more ardent advocates to accomplish great things in times to come. To some, indeed, it appears in the

[12] J. P. Warbasse, *Cooperative Democracy*, New York, Harper & Brothers, 3rd ed., 1936, pp. 26-29. This book is frequently referred to as "the bible of the consumers' movement"

[13] Defined by the cooperatives themselves as savings returned to the consumer, and not profits—a distinction affecting the application of income taxes.

[14] *The Index*, New York, The New York Trust Company, December, 1936, p. 234.

nature of a crusade which is to save the world from communism and fascism, when capitalism shall have spent its force. But to the rank and file it means chiefly, and will doubtless long continue to mean, an agency which enables consumers to circumvent the retailer and effect a saving of, say, 10 per cent on many of their purchases. In the matter of quality, too, the cooperative can render a distinct service to its members, and one which will be more fully appreciated when its importance is more generally recognized. The quality of the goods that are sold cooperatively is usually high, but in any event the commodities are honestly described and fairly priced. Many of these products are manufactured to specifications laid down by the cooperators. For instance, it is now possible to buy cooperatively "a white floating household and bath soap, equal in quality to the most highly advertised 'floating' soap on the market," and at a price roughly one-third less than that charged in grocery stores for soap of equal quality sold under a copyrighted name. Here is an example of cooperation providing both low price and assured quality; and in many cases the latter may be even more important than the former.

Ordinarily, consumers' cooperatives are organized on a very small scale, and expand gradually as their service attracts new members. In urban and suburban communities they often start as cooperative buying clubs, organized by white-collar or professional people. The commodities handled may include groceries, fruits and vegetables, dairy and poultry products, dentifrices and simple cosmetics made up to formulae, gasoline, and a variety of other articles used by the average family. In rural sections of the country, such farm supplies as fertilizers, seeds, feed for cattle and poultry, binder wire and twine, spraying materials, paint, tires, and lubricating oils, are often handled more extensively than the usual household goods. It is estimated that there are in the United States three times as many cooperative associations handling petroleum products and stock feed as there are handling groceries.[15]

The principle of cooperation has also been applied to the sale of electrical power, the extension of credit (through credit unions), the writing of insurance, and various other services. An interesting development is "a chain of eleven cooperative cafeterias in

[15] *Fortune,* March, 1937, pp. 142, 144. The article, "Consumer Cooperatives," in that issue of *Fortune,* was pronounced by the Cooperative League "the best and most recent picture of the current development" of the movement. Many of the data here presented were borrowed from this article.

New York City which has been operated successfully for fifteen years by Consumers' Cooperative Services. The chain has added two new units during the depression, while paying its employees 30 per cent more than the N.R.A. minimum wages."[16]

Retail, Wholesale, and Producing Consumers' Cooperatives.—There are approximately 6500 *retail* cooperative associations in this country, with a total membership of some two million people. This means that "two million United States families, most of them in farm areas, are already saving themselves money by doing cooperative buying."[17] In 1936, these retail cooperatives did a gross business of $500,000,000, an increase of 18 per cent over 1935.[17] It is authoritatively estimated that the retail consumers' cooperatives of thirty-three countries sold nearly two billion dollars' worth of goods in 1935.[18]

Retail cooperatives buy their stocks of goods as advantageously as possible, striving to get high-quality goods at low prices. However, since the individual retail cooperatives are often too small to bargain successfully with producers, they have set up in the United States twenty-six large regional *wholesale* cooperatives, which buy from the factories and sell to the retail associations, to which they rebate the wholesale profits.[19] These wholesale cooperatives enter into contracts with manufacturers, packers, and canners. The contracts are for staple goods, made to laboratory specifications. In this way the retail cooperatives are enabled, as we have already suggested, to supply their members with goods of a known quality.

One of the large wholesale associations is National Cooperatives, Inc., of Chicago, which makes contracts for bulk products such as oil, binder twine, feed and fertilizers, and did $25,000,000 worth of business in 1935.[20] The Cooperative Grange League Federation Exchange, Inc., of Ithaca, New York, is said to have done a $24,000,000 business in feed, seeds, fertilizers, and other supplies during the fiscal year ending June 30, 1935. Looking at the volume of business transacted by wholesale cooperatives throughout the world, we find that more than a billion dollars' worth of

[16] *New Republic,* May 6, 1936, p. 360.
[17] *Fortune,* March, 1937, p. 133.
[18] *Consumers' Cooperation Throughout the World in 1935,* Washington, United States Bureau of Labor Statistics, Serial No. R 499, p. 4.
[19] *Fortune,* March, 1937, p. 133.
[20] *Ibid.,* p. 140.

goods were handled by the cooperative wholesale associations of twenty-eight countries in the year 1935.[21]

"When consumer cooperatives reach a certain stage in their development, they tend to work back toward *producing* or *processing* the goods they sell to their members."[22] However, very little has been done in this field in the United States, where practically the only examples of cooperative production are the manufacture of bakery goods by one wholesale association, the manufacture of feed by two organizations, and the compounding of motor oils by three others.[23] The goods manufactured by the wholesale cooperative associations of sixteen leading countries had a total value of approximately $270,000,000 in 1935.[23]

Consumers' Cooperation by Mail.—A recent development in the movement is the mail-order business carried on by Cooperative Distributors, Inc., of New York City.[24] This organization publishes a monthly journal, *Consumers Defender,* which, in addition to encouraging the organization of local cooperatives and giving advice upon certain problems of consumers, lists a wide variety of commodities which Cooperative Distributors sells by mail. One feature of this service is that the goods listed are described accurately and often at considerable length; another is that Cooperative Distributors goods, which are frequently manufactured to "CD" specifications, are usually sold at prices lower than those charged by local merchants for goods of uncertain quality. Cooperative Distributors claims to sell only commodities which are made under good labor conditions and at fair wages.

Consumers' Cooperation in Other Countries.—The cooperative movement in general has met with greater success in Europe than in the United States; and so, too, has that phase of the movement with which we are now dealing. England, the home of the original Rochdale Pioneers, remains the outstanding example of consumers' cooperation in number of members and volume of business transacted. About one-half of the families of England belong to cooperatives, and the cooperative stores there do about one-eighth of the total retail business of the country. The English Cooperative Wholesale Society, which was formed in 1863 and now consists of more than a thousand societies, "is the biggest

[21] *Consumers' Cooperation Throughout the World in 1935,* p. 10.
[22] *Fortune,* March, 1937, p. 137.
[23] *Consumers' Cooperation Throughout the World in 1935,* p. 14.
[24] 30 Irving Place, New York City.

distributing organization in the British Empire. It has a $700,000,000 bank, a $100,000,000 insurance company. It owns its own steamships, coal mines, olive groves, and, with the Scottish Wholesale, the world's largest tea plantations. It is the No. 1 buyer of Canadian wheat, the No. 1 British miller, No. 1 shoemaker, and second only to Lever Brothers in soapmaking. Its factories turn out everything from corsets to oil cake, from automobiles to saddlery."[25] The "surplus-savings" of the English consumer cooperatives in 1934 amounted to about $125,000,000.

We shall not be able to examine in detail the status of consumers' cooperation in each of the countries in which it has gained a foothold. We may, however, present a few significant figures. Despite the efforts of the fascist dictatorships to destroy the consumers' cooperatives, these associations in 1935 transacted business amounting to $157,000,000 in Germany and $62,000,000 in Italy. The amount of business done in that year by consumers' cooperatives in other countries is indicated by the following figures: France, $92,000,000; Finland, $84,000,000; Denmark, $76,000,000; Switzerland, $63,000,000; Czechoslovakia, $52,000,000; Norway, $35,000,000; Australia, $31,000,000; and the Netherlands, $26,000,000. As we have already noted, the total 1935 sales of consumers' cooperatives in thirty-three countries totaled nearly two billion dollars.[26] In several countries that are particularly well served by cooperatives, the portion of total retail trade handled by the cooperative stores is approximately as follows: Finland, 25 per cent; England, 15 per cent; Denmark, 15 per cent; and Sweden, 10 per cent. A comparable figure for the United States is 1.3 per cent.[27]

The Future of Consumers' Cooperation.—We have said little by way of appraisal of the consumers' cooperative movement, for it has seemed best to allow the facts to speak for themselves. Nor shall we undertake to predict the future of consumers' cooperation, since it is scarcely the function of the economist to indulge in prognostication. It can do no harm, however, to note the observation of Roger Babson, the business men's counselor, that "merchants who laugh off these consumers' crusades are sitting on dynamite"; and the following comment from *Printers' Ink*, a trade journal: "If co-ops are to be viewed with alarm as poach-

[25] *Time*, July 13, 1936, pp. 61, 62.
[26] *Consumers' Cooperation Throughout the World in 1935*, pp. 4, 5.
[27] *Fortune*, March, 1937, p. 139.

ing on the preserves of private business, there is plenty of room for alarm." Further indications that consumers' cooperation may be destined for bigger things are the interest shown in the movement by the Roosevelt administration, which sent a commission to Europe to study the operation of consumers' societies there; and the gift of $1,000,000, made by the late Edward A. Filene, the Boston merchant, to assist in the establishment of cooperative department stores.

On the other side of the picture is the stubborn fact that the movement has been slow to catch on in the United States. The half-billion-dollar business transacted by consumers' cooperatives in 1936 constituted only 1.3 per cent of our total retail trade; and three-fourths of the goods these cooperative stores sold to their members were not *consumers' goods,* in the strict sense of the term, but were seeds, fertilizers, stock and poultry feed, and other *producers' goods* needed in carrying on the business of farming in our great agricultural states. There can be little doubt that the recent spurt taken by consumers' cooperation in the United States resulted, at least in part, from the hardships suffered in the post-1929 depression. "Years of general prosperity are usually lean years as regards the spread of the cooperative philosophy. That philosophy is primarily an economic one, making its appeal first to the financial self-interest of the individual, by the possibilities of savings that it offers. When times are good, when wages are high and money is plentiful, such small savings as the cooperative society offers make little appeal to the average wage earner in this country, especially considering the effort involved in obtaining these savings."[28]

Consumers' cooperation has demonstrated that it can help the consumer to get low prices and high quality, and thus increase the utility obtainable through the expenditure of his money income. It has shown, through its wide spread in many European countries, that it is capable of attaining formidable proportions under favorable conditions. Whether the economic conditions in America and the temper of the people will prove suitable for its continued and extensive growth, we do not pretend to know; and on this point we decline to hazard a guess.

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[28] "Organization and Management of Consumers' Cooperative Associations and Clubs," *Bulletin No. 598,* Washington, United States Bureau of Labor Statistics, p. 1.

1. Define "waste in consumption."
2. What did Ruskin mean by "illth"?
3. Professor Hobson says that "everyone will admit that many sorts of marketable goods and services are injurious alike to the individuals who consume them and to society." Name as many items of this kind as you can.
4. If society should decide to prohibit the production of "illth," what definition of this term can you suggest for deciding whether a specific commodity should or should not be outlawed?
5. "Most good things are capable of being turned to bad uses." What is the significance of this statement in connection with maximizing utility in consumption?
6. "Waste in consumption is closely related to economic inequality." Explain.
7. What justification is there for saying that progressive taxation is based upon the Law of Diminishing Utility?
8. How might the provision of public relief during the depression be construed as a move in the direction of greater equality in the distribution of income?
9. The desire for distinction leads almost inevitably to waste in consumption. Explain.
10. What is the significance of the statement that "there is a hierarchy in the realm of conspicuous spenders"?
11. Give examples of the failure to maximize utility in consumption because of carelessness in the purchase and use of goods.
12. It is commonly assumed that high price means high quality, since "you get just about what you pay for." Argue that this notion is or is not correct.
13. Since some people delight in outdoing others in displaying their costly possessions, on what ground may it fairly be said that indulgence in conspicuous consumption involves waste in consumption?
14. What evidence is there that the ignorance of buyers leads to waste in consumption?
15. In what respects is the service of Consumers' Research and the Consumers Union more useful to consumers than that of the Good Housekeeping Institute?
16. State your views on the probability of a customer making a "best buy" among a half-dozen brands of a given good (say, soap) offered for sale by a department store. Explain how Consumers' Research or the Consumers Union might aid in making a sound choice.
17. Do you regard present-day advertising as an aid or a hindrance to the wise purchase of consumers' goods? Why?

18. Sketch the origin and growth of the Rochdale Society of Equitable Pioneers.
19. On what basic principles was the Rochdale Society founded?
20. What is the goal of consumers' cooperation, as set forth by the Cooperative League?
21. What varieties of commodities are handled by (a) urban and (b) rural consumers' cooperatives?
22. Describe the nature and extent of *retail, wholesale,* and *producing* consumers' cooperatives.
23. Describe the achievements of consumers' cooperation in England.
24. In what other countries, and to what extent, has the consumers' cooperative movement made progress?
25. What is your feeling about the future of consumers' cooperation in the United States? Upon what facts do you base your opinion?

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16 ECONOMIC INEQUALITY: EXTENT AND CONSEQUENCES

THE EXISTENCE OF ECONOMIC INEQUALITY IS APPARENT EVEN TO THE LEAST OBSERVANT. IN MOST INSTANCES, PERHAPS, THIS knowledge comes to an individual through observing that his economic status does not compare favorably with that of certain other individuals. Nearly every man is painfully aware, at one time or another, that his dwelling, his automobile, or his theater seats are inferior to those of some other members of society, and readily understands, in most instances, that the fault lies in the leanness of his purse—that is, in the inadequacy of his income. Relatively few, however, realize the extent of inequalities in income in the great industrial nations, and still fewer give serious thought to the consequences of these inequalities, which affect gravely many phases of human life.

The truth is that economic inequality, as it exists in the United States today, means poverty for many in this land of plenty, and makes a grim joke of the American tradition of equality of opportunity. Inequality breeds inequality, and thus perpetuates a condition that keeps some persons from attaining the full development of their abilities, and from competing effectively with others of equal talents whom fortune has cast in happier rôles. The problem of economic inequality, as we see it, is one of insuring equality of opportunity for all members of society, in so far as this can be accomplished through the removal of artificial obstacles to the full development and utilization of personal capacities.

Some Data on Distribution of Income

Statistics of the distribution of income in the United States, like so many kinds of economics statistics, are available only in fragmentary form. We shall have to manage with figures gathered from several sources—figures which, though admittedly unsatisfactory in some respects, serve nevertheless to indicate the major groups of incomes in this country, ranging from those

too small to buy even a "health and decency" standard of living to incomes so huge as to encourage the most extravagant spending. The data of American incomes most often referred to in recent years are those calculated by the National Bureau of Economic Research for the year 1918, and summarized in Table 21.[1] The

TABLE 21.—DISTRIBUTION OF PERSONAL INCOMES IN 1918[a]

Income Class	Persons		Income	
	Number	Per Cent	Amount	Per Cent
Under zero[b].	200,000	.5324	$ − 125,000,000	− 22
$ 0–$ 500. . .	1,827,554	4 8645	685,287,806	1 18
500– 1,000. . . .	12,530,670	33.3537	9,818,678,617	16 94
1,000– 1,500 . .	12,498,120	33.2670	15,295,790,534	26 40
1,500– 2,000. . .	5,222,067	13 8999	8,917,648,335	15 39
2,000– 3,000 . . .	3,065,024	8.1584	7,314,412,994	12 62
3,000– 5,000 . .	1,383,167	3.6817	5,174,090,777	8 93
5,000– 10,000. . . .	587,824	1.5646	3,937,183,313	6 79
10,000– 25,000. . . .	192,062	.5112	2,808,290,063	4 85
25,000– 50,000. . .	41,119	.1094	1,398,785,687	2 41
50,000– 100,000 . .	14,011	.0373	951,529,576	1 64
100,000– 200,000 . .	4,945	.0132	671,565,821	1 16
200,000– 500,000. . .	1,976	.0053	570,019,200	.98
500,000– 1,000,000. . . .	369	.0010	220,120,399	.38
1,000,000 and over	152	.0004	316,319,219	55
	37,569,060	100 0000	$57,954,722,341	100 00

[a] Source: National Bureau of Economic Research, Inc.
[b] This group is made up of individuals and concerns whose "balance sheets" for the year showed *net losses*, though their *gross incomes* were large enough to require them to file income tax returns.

Bureau's study was based primarily upon income tax returns of the United States Bureau of Internal Revenue, but included other data, thought to be reliable, that were collected from many sources. The net result is an estimate of income distribution that, unfortunately, has not been equaled since for comprehensiveness and probable accuracy. Because of the excellence of these data, we present them rather than less enlightening figures of later years, with the feeling that, supplemented by some more recent estimates, they give a fair picture of the extent of inequality in post-war American "good times."

[1] Adapted from *Income in the United States*, New York, Harcourt, Brace & Company, Inc., 1921, vol. 1, pp. 136, 137.

This study by the Bureau of Economic Research indicated that "the most prosperous 1 per cent of the income receivers had nearly 14 per cent of the total income, the most prosperous 5 per cent of the income receivers had nearly 26 per cent of the total, the most prosperous 10 per cent of the income receivers had nearly 35 per cent of the total, and the most prosperous 20 per cent of the income receivers had about 47 per cent of the total income."[2] It showed, further, that 86 per cent of the persons "gainfully employed" in this country in 1918 had incomes of less than $2000 for the year, and 72 per cent had incomes of less than $1500.

There are no figures for later years that are comparable to these estimates, except for incomes of $5000 per year and more. However, if we examine the *income tax returns* for 1929 (our latest year of great prosperity) as reported by the Bureau of Internal Revenue, in connection with careful estimates of the *total national income* and the *total number of gainfully employed,* we arrive at some significant conclusions. We find that in 1929 the most prosperous 1 per cent of income receivers got 14.44 per cent of ninety billion dollars, the total estimated national income for that year, the most prosperous 2.25 per cent got 18.66 per cent, and the most prosperous 8 42 per cent (which included all who filed income tax returns, totaling 4 million persons) got 27.55 per cent of the total. The remaining eleven-twelfths, numbering some 44 million persons, obviously received, if single, incomes of less than $1500, or, if married, incomes of less than $3500, since all others were required by law to file returns. Indeed, a simple calculation shows that the *average income* received by the gainfully employed *who did not file income tax returns* was $1477. Since most of the low incomes in an industrial country are those received in the form of wages, we may note the fact that studies of average weekly earnings in twenty-four manufacturing industries, made by the National Industrial Conference Board, indicated that the *annual earnings* of all workers in these industries averaged $1498 in 1929, when calculated on the basis of *full-time* work, for fifty-two weeks of the year. For skilled male workers, the average was $1699, and for unskilled male workers $1330.[3] The

[2] *Ibid.,* p. 147.

[3] *Wages in the United States, 1914-1930,* New York, National Industrial Conference Board, Inc., 1931, p. 214.

Board's estimate of average annual earnings of all workers in these industries, figured on a full-time basis, was $1407 for the year 1937.

A further set of figures, to which we shall have occasion to refer in the next chapter, is given in Table 22.[4] We see here that

TABLE 22.—PERCENTAGE DISTRIBUTION OF TOTAL INCOMES IN INCOME TAX RETURNS FOR 1929, BY NET INCOME CLASSES, SHOWING DISTRIBUTION BETWEEN INCOMES FROM WAGES AND SALARIES AND FROM PROPERTY[a]

Net Income Classes (thousands of dollars)	Percentage from Wages and Salaries	Percentage from Property
Under 5 (estimated)	58.81	41.19
5– 10	45 86	54.14
10– 25	32 64	67.36
25– 50	22.61	77.39
50– 100	15 46	84.54
100– 150	11 36	88.64
150– 300	8 48	91.52
300– 500	5.87	94.13
500–1,000	3 75	96.25
1,000 and over	1.83	98.17

[a] Source: United States Treasury Department, Bureau of Internal Revenue.

the larger the income, the smaller is the proportion of the income that comes from wages and salaries, and the larger the proportion from property. For example, almost 46 per cent of the incomes ranging from $5000 to $10,000 a year are made up of wages and salaries, while less than 2 per cent of the very largest incomes (1 million dollars and over) represent payment for personal services. Wages and salaries, then, form only a slight part of the incomes of the very wealthy, but are increasingly important as we move down the income scale, and comprise practically the whole income of the great mass of the gainfully employed. Returns from the ownership of property, on the other hand, are of almost no significance in the incomes of the "working classes," but provide more than one-half of the total incomes of all persons receiving $5000 or more annually, and an overwhelming proportion of the incomes of the very wealthy. Thus we see that there are great inequalities in the distribution of *wealth*, as well as in the distribution of *income*.

[4] Adapted from *Statistics of Income for 1929*, Washington, Government Printing Office, 1931, p 10.

The Consequences of Economic Inequality

But of what significance are these inequalities in the distribution of income? Is there any evidence to show that they result in hardship or injustice? May they not, indeed, be beneficial rather than harmful to society? It is questions such as these that we shall now undertake to answer, by attempting to interpret economic inequality in terms of standards of living, economic security, educational opportunity, legal justice, and the control of government.

Economic Inequality and Standards of Living.—In the present day and age, no one is likely to dispute the statement that there is a close relationship between money incomes and standards of living. Indeed, we may say that a man's standard of living consists of the total of economic goods—commodities and services —that he can buy with his money income. The data on income that we have just examined show clearly that there are wide variations in incomes in this country, and it takes but half an eye to see that standards of living in the United States and other countries vary almost as greatly as incomes. It is a far cry from the scanty diet of the poor to the overloaded tables of the rich, from the thin soles and threadbare clothing of the many to the fur coats and diamonds of the few, from the dingy rooms of most of our wage earners to the palatial residences of our multimillionaires. It is small wonder that we find pale, scrawny children on the East Side of New York, and ruddy, plump boys and girls on suburban estates. We are speaking here of great extremes, to be sure, but between these extremes are gradations in standards of living that run the whole gamut from genuine privation to satiety. It is evident, then, that with inequality in incomes goes inequality in standards of living.

Many attempts have been made to determine the amount of income that is necessary to provide for the basic needs of a family of five. Such an estimate, which was called a "Minimum Health and Decency Budget," was published by the United States Bureau of Labor Statistics in 1919,[5] and has been brought up to 1929 by the Labor Bureau, Inc. The budget includes the following items:

[5] *Monthly Labor Review,* December, 1919, pp. 22-29.

1. Nourishing food.
2. Houses in low-rent neighborhoods and with the smallest possible number of rooms consistent with decency (about four rooms and a bath).
3. The upkeep of household equipment, but with no provision for the purchase of additional furniture.
4. Clothing sufficient for warmth, but with no further regard for style than would permit one to appear in public without slovenliness or loss of self-respect.
5. Services of doctor, dentist, and oculist, $80; amusement and recreation, $20; union dues, $10; church and religious organizations, $13; incidentals, $52.

It should be borne in mind that this is a *minimum* budget, and one which, according to the Bureau of Labor Statistics, "does not include many comforts which should be included in a proper 'American Standard of Living.'" The Bureau found that this standard of living could be purchased in Washington, D. C., in 1919, for $2262.47. In 1921 and 1922, the items of this budget were priced in ten cities, the total cost running from $2000 to $2500. The Labor Bureau, Inc., estimated the budget, in 1929, as costing from a minimum of $2055.66 in Schenectady, N. Y., to a maximum of $2532.84 in San Francisco, Cal., with an *average* cost of $2318.63 for ten American cities. Commenting on these figures, the Labor Bureau says that "no yearly earnings which fall below $2055.66 in any section of the country can be considered a living wage, since the total represents the lowest cost of the meagre budget allowed by the government as the bottom level of health and decency. However, a great many of even the skilled workers in the country do not achieve this level. . . ."[6]

This statement about a "living wage" would obviously be true if we could be sure that *every* wage earner who did not file an income tax return for 1929 got the *average* income received by this group, $1477, and that this was the total income for a family of five. But this is clearly not the case. With 48 million persons gainfully employed in a nation numbering 120 million souls, there are two wage earners available on the average for every family of five. However, this statement has little meaning, since we know nothing of the distribution of wage earners among families.

[6] *Facts for Workers,* The Labor Bureau, Inc., 2 West 43rd Street, New York, September, 1929, p 2.

There might, for example, be but one wage earner in a family of seven, while in a family consisting of man, wife, and a child of sixteen, all three could be drawing wages. We see, therefore, that an *average income* of $1477—or, using the National Industrial Conference Board's estimate and assuming full-time employment, an average wage of $1498—combined with a cost of $2055.66 for a minimum standard of living for a family of five, does not necessarily mean that *all* of these wage earners are living below the standard of health and decency. However, it is doubtless true that there are many families of five or more persons in which the total income received is less than the minimum of $2055.66, and in these instances there is real cause for apprehension and need for a remedy. Clearly, if the estimates of the National Industrial Conference Board are correct, the average *skilled* male worker in America is unable, with his *full-time* earnings alone, to support a wife and three children on a "health and decency" basis. He must be assisted by other members of the family to the extent of at least $300 a year if this so-called "minimum standard" is to be attained. For the average *unskilled* male worker, the shortage is at least $670.

The lack of exact data relative to these unfortunate members of society must not be allowed to blind us to the fact that poverty does exist. "Poverty," says Dr. Robert W. Kelso, "is that condition of living in which the individual, whether from lack of means or the failure to apply them, consistently fails to maintain himself, and those properly dependent upon him, at a plane of living high enough to insure continuous bodily and mental fitness to carry on permanently in his occupation and locality; and which allows him and them to live and function in their community with decency and self-respect."[7] With this concept of poverty in mind, Dr. Kelso reaches the conclusion "that the unskilled laborers of America live in poverty; and that of those who work with their hands but are nevertheless skilled, from a third to a half possess [under our present social arrangements] neither the means nor the potentiality for the maintenance of a minimum standard of social competency."[8] To this statement may be added the estimate of Stuart Chase, that "some 80 per cent of all American families lived below the budget of health and decency in 1922, and the

[7] Robert W. Kelso, *Poverty,* New York, Longmans, Green & Company, 1929, p. 21.

[8] *Ibid.,* p. 54.

20 per cent increase in per capita income since that date, while it has helped to be sure, still leaves probably two-thirds of all families below the line."[9]

Some actual surveys that have been made of *family incomes* throw some light upon the question of poverty. In 1918, the United States Bureau of Labor Statistics studied the incomes of more than 12,000 families (average size, 4.9 persons per family) in 92 localities of 43 states, and discovered that the average *family income* was $1513, or $700 less than the Bureau's health and decency budget in 1919, when general prices were substantially the same as in 1918.[10] A study of 100 families in Muncie, Indiana, in 1924, revealed the fact that the *total family income* of 74 of these families was below the budget estimate of the Bureau of Labor Statistics.[11] An inquiry into the incomes of 467 families of unskilled workers in Chicago, in 1924, showed that slightly more than one-half of these families were able, *with income from all sources,* to meet the Chicago Standard Budget for Dependent Families, placed at $1548.84, *over and above rent.*[12] A survey of Philadelphia family incomes, made in 1928 under the auspices of the *Public Ledger* of that city, indicated that "50 per cent of the families have an income of less than $2000 yearly."[13] A study of the incomes of 536 working-class families, conducted by the New York State Department of Labor, showed that "half of the families had an income which was less than the amount necessary to maintain a standard of living at a minimum of decent subsistence for a family of five."[14] Finally, there is the estimate of the Brookings Institution, to the effect that about 12 million families in the United States, or more than 42 per cent of the total, had *family incomes* of less than $1500 each in 1929.[15] These scattered investigations, and others leading to similar conclusions, are sufficient proof that poverty does exist

[9] Stuart Chase, *Prosperity: Fact or Myth?* New York, Albert & Charles Boni, Inc., 1929, p. 176.

[10] *Monthly Labor Review,* December, 1919, p. 41.

[11] Robert and Helen M Lynd, *Middletown,* New York, Harcourt, Brace & Company, Inc., 1929, p 85.

[12] Leila Houghteling, *The Income and Standard of Living of Unskilled Laborers in Chicago,* Chicago, University of Chicago Press, 1927, p 130.

[13] *Philadelphia,* Chamber of Commerce, Philadelphia, January, 1929, p 14.

[14] Stuart Chase, *Prosperity: Fact or Myth?* pp 86, 87.

[15] Maurice Leven, Harold G Moulton, and Clark Warburton, *America's Capacity to Consume,* Washington, Brookings Institution, 1934, p 55

in the United States, though to what extent it is impossible to say with any degree of accuracy or assurance.

If these total family earnings are at all representative of the incomes of large numbers of the people of the country—and we believe that they are—it follows that there is widespread poverty in this richest of all nations. But is this poverty the result of inequality of distribution, or does it arise, rather, from the fact that our national income is not large enough to provide a satisfactory standard of living for the country as a whole? The answer to this question may be found in the *per capita* income of the United States. If we start with a national annual income of 90 billion dollars, and deduct 15 billions (our estimated annual savings in 1929) for additions to industrial equipment, we have left some 75 billion dollars available for the purchase of consumers' goods over a twelve-month period. If production did not decline under a régime of strict equality, we could divide this amount on a per capita basis, giving $625 to every man, woman, and child, or a total of $3125 for a family of five. Though we are not here advocating absolute equality of incomes, either for all members of society or for all engaged in economic activities, we believe that these figures indicate that poverty is attributable to our system of distribution and not to a shortage of economic goods. An allowance of $3125 would seem appallingly low to a considerable fraction of our people, but it would raise materially the standards of living of the rank and file, and would unquestionably convert the United States into a country in which poverty was virtually unknown, if the cost of living remained unchanged.

In an earlier chapter,[16] we showed that inequalities in wealth and income lead to conspicuous consumption, and argued that a move in the direction of equality would tend to reduce waste of this kind. This is almost necessarily the case, for there would be but little point to an attempt to "show off" through competitive spending in a society in which incomes were wholly, or even approximately, equal. The attractiveness of conspicuous consumption lies chiefly in the ability to spend on a scale so grand that at least some other members of society are outshone. In a society in which incomes range from hundreds to millions, there is likely to be a very large number of "income classes," with each class striving to outdo the class immediately beneath it in the scale. But in a society in which incomes were equal, there

[16] Chap. 15.

would be little incentive, as well as little opportunity, for conspicuous spending. The fact that any family, by virtue of the equality of money incomes, could match the spending of any other family, would detract immensely from the zest of the game and would, in all probability, sound the death knell of this silliest and most wasteful of all types of display.

In dealing with waste in consumption, we distinguished between individual and social waste of this kind. We suggested that there is *individual waste in consumption* whenever an individual, for any reason whatsoever, fails to secure the maximum of utility through the expenditure of his money income, and *social waste in consumption* whenever society fails to get the maximum of total utility from whatever goods are produced by society as a whole. We indicated, further, that, in the presence of considerable differences in individual incomes, the attempts of individuals to maximize the utility to be derived from their money incomes may easily lead to social waste in consumption. Indeed, it is scarcely too much to say that the elimination of both individual and social waste in consumption can be attained, if at all, only in a society in which incomes are substantially equal. An acceptance of the Law of Diminishing Utility leads to the conclusion that, in all probability, the greatest possible social satisfaction is dependent upon approximate equality of money incomes. If, then, we should ever achieve such an equality, we might expect also to achieve the maximum social satisfaction; and it is conceivable that we might have, at the same time, the maximization of satisfaction from the expenditure of individual money incomes—in which case we should have eliminated waste in consumption!

It is a commonplace that "money talks," and it appears to talk loudest and most effectively when it is concentrated in considerable quantities. The "demand" for an article consists, of course, not only of desire for the good but also of purchasing power to back up that desire. As a consequence of this fact, the things that rich men want are more likely to be produced than the things that poor men need. If a Philadelphia millionaire wants a $5,000,000 private yacht while workingmen need small, sanitary houses, the yacht is built and the workers and their families continue to live in tenements. Whenever agents of production are diverted from the making of necessities and used in the manufacture of luxuries, there is a tendency for the prices of necessi-

ties to rise, so that the person of small income gets less for his money than he would have been able to get if luxuries were not produced. Obviously, there would be no \$5,000,000 private yachts,[17] \$1,000,000 "coming out" parties,[18] \$60,000 sable coats,[19] or \$2000 silk hosiery,[20] if incomes were anything like equal; and as a consequence the plain, substantial goods that minister to the needs of the many would be produced in larger quantity and sold at smaller prices than at present.[21] Furthermore, there can be no doubt that many poorly paid persons now spend a part of their incomes for the sake of keeping up appearances, and under existing circumstances such spending may be necessary for the maintenance of self-respect. But an equality, or near-equality, of incomes would eliminate most of the shining examples of ostentatious display, and would make feasible the expenditure of incomes for solid comforts instead of for the tawdry jimcracks that class conventions make necessary today.

Economic Inequality and Economic Security.—A study of present-day economic life shows that fluctuations in business activity lead to instability of income that affects, to a greater or lesser degree, the members of all of the many income groups found in our economic organization. However, it should be clear, from the chapters dealing with economic insecurity, that variations in income do not affect all groups in the same manner or to the

[17] The *Savarona*, built for Mrs. Richard M. Cadwallader of Philadelphia in 1931, is said to have cost this sum. This "finest private sailing vessel the world has ever seen" is manned by a crew of seventy. (*New York Times*, July 19, 1931, and October 11, 1931.)

[18] "Auditors of the Mayflower Hotel, in Washington, report that the famous party which Mr. H. L. Doherty, of Cities Service, threw there in honor of his adopted daughter, cost him a cool million dollars, or, in other words, \$500 for each of his 2000 guests." (*New Republic*, January 7, 1931.)

[19] The *New York Tribune*, of September 25, 1921, listed some of the personal possessions of Mrs. Edward Henry Smith Wilkinson, of Nottingham, England, including \$3,400,000 worth of jewelry, \$128,000 worth of gowns, \$64,000 worth of hats, and a \$60,000 sable wrap. (Cited in Stuart Chase, *The Tragedy of Waste*, p. 90)

[20] In the *Philadelphia Bulletin*, of October 5, 1931, appeared a picture of "the most expensive hosiery in the world." They were made "of sheerest chiffon, ornamented with diamonds set in pendants of platinum," and cost \$2000 per pair.

[21] In this statement is found the answer to a question that is often asked, Does not the extravagant spending of the rich benefit the poor by providing them with work? The concentration of money *does* lead to a demand for expensive goods, and thus it provides employment. But this money, if more equally distributed, would still lead to a demand for goods—though, as we have suggested above, for goods of a simpler type—and there is no reason to suppose that it would provide any less employment than when spent for luxuries.

same extent. When industrial depression forces a successful manufacturer to close down his plant temporarily, his manner of living and that of his family are not, as a rule, substantially altered. He may have to dispense with one or two of his cars, to get along with fewer servants, and perhaps to take his family on a relatively inexpensive trip to Europe during the summer season, instead of opening up his elaborate and costly warm-weather retreat in the Adirondacks. But in so far as his needs and most of his comforts are concerned, he does not suffer. He does not have to cut down on his consumption of meat, his children need not go without milk, nor are he or his dependents in danger of eviction from their home for non-payment of rent.

But it is precisely these hardships, and others of similar nature, that must be endured by the families of many workingmen whenever a serious business depression overtakes society; and this, judging from past experience, means at least once in every decade. In our discussion of unemployment, we gave some attention to the human suffering caused by a shortage or total loss of income during periods of depression. There is no need to multiply the harrowing details, as related by social workers. That privation is the portion of many in our years of industrial blight is evident from that fact that, in the great depression of 1929, less than five dollars a week *per family*, provided by a Relief Committee, was the sole income of most of the unemployed of Philadelphia who received aid from this Committee. Certainly, a very large number of the 16 million unemployed Americans fared no better than the jobless citizens of Philadelphia and other great cities. The wealthy and middle classes may have to "retrench" at times, as we have indicated above, but they know nothing at first hand of the "skimping" that falls to the lot of millions of members of the so-called working class.

The hazards of occupational disease and industrial accidents fall very heavily upon the wage-earning group. We noted in Chapter 4 the inadequacy of the accident compensation laws of most of our states. Except in so far as hospitalization and medical treatment are provided through social or governmental agencies, the cost involved in securing these vital services either places them beyond the reach of the average worker or, by consuming a part of his income, crowds other essential items out of his meager family budget. The outcome of this situation is that many people who need medical attention fail to get it In a nation-wide survey

conducted in 1938, the American Institute of Public Opinion found that 42 per cent of those interviewed throughout the country said that they had put off going to the doctor, at some time or other, because of the cost.[22] And, of course, the loss of working time that results from accident or illness affects the worker's income in a way quite outside the experience of those whose incomes are derived from property. Interest and dividends are wholly independent of the health of their recipient. The fact that he is well or sick, working or idle, does not affect the regularity or the size of such payments. Wage incomes, on the contrary, depend upon the health of the worker in the sense that usually they are promptly cut off if ill health interferes with his ability to engage in productive work.

The rich get old as surely as do the poor, though perhaps not so rapidly, if we think in terms of physical deterioration, since they are able to get the best medical and surgical attention that money will buy. In the preservation of health, more fully than in most matters, it is true that a stitch in time saves nine. The great age of some of our millionaires is at least partly attributable to their ability to engage the services of personal physicians, whose duty it is to keep their employers in health, and to the fact that any aid to health—such as residence in Florida in winter and in Maine in summer—is well within their reach. But whether physical decline comes soon or late, economic old age, in the form of loss of income, overtakes large numbers of our citizens and, in effect, makes beggars of them. The prospect of old age seldom holds for the rich the same fear of dependency that it holds for the poor. We have already seen that of all persons in this country who attain the age of sixty-five, two-thirds are dependent upon public or private charity, either wholly or in part. Now, no one would contend that the groups whose incomes appear in the upper income brackets—that is, the well-to-do and the wealthy—furnish their per capita share of these aged paupers. The specter of old age dependency is reserved almost exclusively for the contemplation of the propertyless masses—those who have no personal stake in the great accumulation of national wealth of which even they have been taught by press and public school to be proud.

We are concerned here not with the *manner* in which economic insecurity causes the annual incomes of millions of our people

[22] *New York Times,* June 11, 1938.

to be lower than they would otherwise be, but with the fact that, because their customary wages are low, a loss in income is a much more serious matter to them than to those whose normal incomes are high. Coming events cast their shadows before, and the psychological effects of the temporary or permanent loss of economic competency long precede the fact, because of the worker's ever-present fear of that loss. Its physical effects are paraded before his very eyes, as he sees his children stunted, both physically and mentally, by his inability to secure the steady income needed to provide for their proper development.

Furthermore, whatever uncertainties the incomes from property may be subject to, it is evident that variations in these incomes do not lead to such grave effects upon the lives of their recipients as are produced by fluctuations in wage incomes upon the daily lives of the large percentage of our population that find it impossible to accumulate property. Wage incomes do not permit of expansion to meet the needs of emergencies. As one writer has pointed out, "a wage or salary can rarely be capitalized in times of special need, such as illness (except by means of insurance payments), while income from property, unless the capital is 'tied up,' can within limits be increased at will, by selling or mortgaging part of the principal."[23]

Economic Inequality and Educational Opportunity.—According to figures compiled by government officials, approximately one-fourth of the total population of the United States was enrolled in schools and colleges in the prosperous year of 1928. Table 23 shows the distribution among the several classes

TABLE 23.—ENROLLMENT IN SCHOOLS AND COLLEGES IN THE UNITED STATES, 1928[a]

	Number	Per Cent
Elementary and kindergarten	23,503,416	80.7
Secondary schools	4,321,361	14 8
Colleges and normal schools	1,143,141	3.9
Private commercial and business schools	188,368	0.6
Total	29,156,286	100.0

[a] Source: *Statistical Abstract of the United States, 1930*, pp. 107–110.

[23] Josiah Wedgwood, *The Economics of Inheritance*, London, George Routledge & Sons, Ltd., 1929, p. 10.

of educational institutions. The enrollment was heavy in the elementary schools, but decreased greatly in the secondary schools, and still further in colleges and normal schools. If all children were to continue their education through high school and college, we should expect the number of secondary and college students together to approximate the enrollment in elementary schools, since the elementary work covers as long a period of time as the high school and college work combined. We find, however, only one-fourth as many students in secondary schools and colleges as in elementary schools. A rough and admittedly inexact calculation indicates that of every group of 100 elementary students, fewer than 30 reach the high school, while only about 10 get the advantage of college or other advanced training.

We have no intention of suggesting that all students who fail to get to high school or college are the victims of economic inequality. As everyone knows, there are many boys and girls who are so lacking in ability that they simply cannot "make the grade," while others detest mental exertion so heartily that they insist on ending their formal education at the earliest possible moment. The fact remains, however, that education—even "free" education—is costly, and large numbers of boys and girls with good minds and abundant ambition are forced by economic necessity to get along without it. The existence of child labor on a large scale[24] in some sections of the country means that even an elementary education is beyond the reach of a considerable portion of the population. Laws providing for compulsory school attendance, but specifically exempting children whose parents cannot supply them with proper clothing—as do the laws in some of our states—are sufficient evidence that education may be "free" and at the same time so expensive that members of our low-income groups are unable to take advantage of it. We have here, in all probability, at least a partial explanation of the fact that in 1930 there were 4,283,753 illiterates in the United States.[25] This number included 4.3 per cent of the total population over ten years of age.

Despite the growth of tax-supported elementary schools and high schools, and the great development of state universities, it

[24] In 1920, there were 1,060,858 children, between ten and fifteen years of age, inclusive, "gainfully employed" in the United States. By 1930, the number had been reduced, probably by the depression, to 667,118. See *Statistical Abstract of the United States, 1937,* p. 53.

[25] *Ibid.,* p. 41.

still remains relatively true that learning and the paraphernalia of culture are readily available to the children of the well-to-do, but difficult of attainment by the poor. When the son of a coal miner quits school as early as the law allows, or as soon as he can get his working papers, we are not surprised. If the son of a rich man fails to get his bachelor's degree, it is a matter for inquisitive comment. The "health and decency budget" of the American worker includes no allowance for "higher education," but the son of the wealthy business or professional man goes to college as a matter of course, and spends in a college year a sum greatly in excess of the average *total family income* of the unskilled or semi-skilled workers of this country.

The oft-repeated statement that anyone who has ability and really wants a college training can get it, is simply not true. It is a bit of pleasant palaver, comparable to the saying that every boy has a chance to be President. The fact is that an ambitious young man may be prevented from going to college or professional school by the absence of a high school training, which was rendered impossible by the necessity of contributing to the family budget in early youth; he may lack the unusual physical stamina that is needed to pursue college studies and earn a living at the same time; and may even find it necessary to help to support his family while paying his own expenses and carrying his college work. Obstacles such as these may easily be insurmountable even for an exceptionally able young man. They are difficulties such as the well-to-do and the wealthy seldom have to face. As a consequence of inequalities in income, the enrollment in our colleges and universities is based very largely on financial status. To a lesser degree, this is true of secondary schools also.

The absence of equal opportunity for education means that the members of families having small incomes are greatly restricted in their choice of occupations. Having made a study of the movement of individuals between classes in England, Professor Morris Ginsberg reached the conclusion that "the social ladder so far lifts only relatively small numbers."[26] The difficulties experienced by working men in rising to higher economic positions have led some Europeans to refer to the United States as the land of unlimited opportunity. However, the data on

[26] Morris Ginsberg, "Interchange Between Social Classes," in *Economic Journal,* December, 1929, p. 565.

American incomes presented in this chapter show that, while we are an extremely wealthy nation, we are not so prosperous as individuals. The all-important consideration is not the *possibility* but the *probability* of "getting up in the world." Inequality of income provides both a large number of persons anxious for economic advancement, and an attractive goal toward which to strive, but it brings so great an inequality of educational opportunity as to make advancement for the masses highly improbable. "A right to the pursuit of happiness," as Mr. R. H. Tawney points out, "is not identical with the right to attain it."[27] Until we have a larger degree of equality of income, it is idle to speak of equality of opportunity.

Economic Inequality and Legal Justice.—Equality before the law is a matter of supreme importance, and civilized nations have long boasted that they provide a legal "square deal" for all persons, of both high and low degree, coming within their jurisdiction. But for some years there has been growing up, in America at least, the notion that the law before which all are supposed to be equal provides one kind of justice for the rich and another for the poor. This unpleasant suspicion arises from the fact that while all citizens may be equal before the law, the machinery through which the law operates works most smoothly and satisfactorily for those who are able to pay a good price. We are not suggesting that judges and juries are susceptible to bribery, though this is occasionally the case. Rather, we have in mind the costliness of legal procedure. The services of lawyers, with certain honorable exceptions, are bought and sold in the open market, as material and labor for manufacture are bought and sold. This means, when combined with the practice of assessing court costs, that equality before the law is little more than a legal fiction, since justice dealt out under such circumstances has a price, just as truly as an automobile, a coat, or a loaf of bread has a price.

It means, moreover, that those whose purses are well lined are enabled—through postponements, appeals, and other legal devices—to put off and often to escape the consequences of violations of the law that would quickly land lesser men behind the bars. The "oil scandals" and other malodorous federal cases that have been aired in fairly recent years indicated clearly that it

[27] R. H. Tawney, *Equality,* New York, Harcourt, Brace & Company, Inc., 1931, p 88.

pays to be well heeled when the law is on one's trail. Indeed, it sometimes appears that the chance of evading punishment for misdeeds is directly proportional to the size of one's bankroll. The wholesale rumrunner is more completely immune from successful prosecution than the retailer who peddles by the pint. The banker who steals on a large scale is less likely to draw a long sentence than the clerk who deals in petty theft. For the vast majority of principals in both civil and criminal cases, as we have already intimated, the lower courts become in fact the courts of last appeal, but for those who have abundant financial resources the higher courts open up almost endless possibilities for the delay and even the perversion of justice. "There is one law for the rich and another for the poor," writes Professor Laski, "whenever the preparation of a defence is an item of importance in the case."[28] Something could be done in the way of aiding justice in our criminal courts, if we were to provide *public defenders* of ability as we now provide *public prosecutors*, so that the defendant's case would be adequately presented regardless of his financial status; but on the whole we need not look for genuine equality before the law until we have achieved at least a reasonable degree of economic equality.

Economic Inequality and the Control of Government.—What has been said about economic inequality meaning inequality in standards of living, economic security, educational opportunity, and access to the courts may seem to some readers to be more or less obvious. In the field of politics, however, we see an aspect of inequality which is much less generally recognized, but which must not on that account be considered less important than the inequalities that we have already noted.

The enthronement of the principles and forms of political democracy, in the late eighteenth and early nineteenth centuries, did not mean that all men were to have an equal voice in government, despite the fanciful dictum, "All men are created free and equal." It meant, rather, that political power was to rest with those who already held economic power. In a capitalistic system of society, economic power is derived chiefly from the ownership of property. It is primarily the distribution of property, therefore, which determines the distribution of political power.

"Government is a form of social organization which has de-

[28] Harold J. Laski, *Grammar of Politics,* New Haven, Yale University Press, 1925, p. 565.

veloped because, in the long run, it has afforded the means of supplying men with certain services more efficiently and more economically than these could have been supplied by each for himself."[29] But precisely which services are to be supplied socially is a question that is not decided merely by setting up a definition of this kind. Whether the provision of electric current, compensation for industrial accidents, or tariff protection against competing commodities should be undertaken by governmental agencies are matters which must ultimately be determined by political means. With strict equality of political power, a laborer would have quite as much influence as his employer in deciding such questions. Henry Ford and his lowliest mechanic, for example, would have an equal voice in determining how high the tax on super-incomes should be. But no intelligent person believes for a moment that this is the situation today.

It is not without significance that when ex-Ambassador James W. Gerard set out to name the actual rulers of the United States, not many years ago, he drew up a list of sixty-four wealthy industrialists and financiers, including a sprinkling of prominent newspaper publishers. In any modern political state, numerous and diverse demands are continually being made upon the government by the citizens. Not all of these demands can be satisfied. Consequently, there must be adopted some process of selection through which the government may choose from among these multitudinous demands those which shall be met, and announce, for instance, "We shall provide pensions for the veterans of foreign wars, but not for the veterans of industry." This process of selection is one of necessity. If an administration is to survive, it must satisfy the demands of that portion of the electorate that is most powerful—that is, of those citizens who, if their wishes are not complied with, will bring about a change in administration. The extent to which individuals can gain recognition of their desires depends, therefore, upon their ability to enforce their demands. The ability to enforce political demands is a function of economic power which, except where labor has mobilized its strength for collective political action, rests primarily upon the ownership of property. To expect any substantial degree of equality of political influence in the presence of great inequality of wealth and income is to assume that men possessed of tremendous economic power will refrain from exercising that power

[29] H. L. Lutz, *Public Finance*, p. 3.

through political channels. That they do not refrain is sufficiently clear from past experience. Rather, by the expenditure of large sums, they influence nominations and elections, and demand that our legislators pass measures that will strengthen them—the propertied classes—in their control of the political machinery of the country. "These men," said Mr. Gerard, in submitting his list of America's "rulers," "are too busy to hold political office, but they determine who shall hold such office."[30] Here, then, is another form of gross inequality that has grown out of economic inequality, upon which it continues to fatten. And here, again, the remedy, if we are to find one, appears to lie in the achievement of a larger degree of equality in the distribution of income.

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1. "Inequality breeds inequality, and thus perpetuates a condition that keeps some persons from attaining the full development of their abilities." Explain.
2. Argue that equality of opportunity does, or does not, exist in the United States today.
3. Cite figures showing that there is inequality in the distribution of income in this country.
4. What was the *average* income received in 1929 by the gainfully employed who did not file income tax returns?
5. "The larger the income, the smaller is the proportion of the income that comes from wages and salaries, and the larger is the proportion from property." From what source is it possible to get information of this kind?
6. What is the meaning of the term "standard of living"?
7. What items are included in a "minimum health and decency" standard of living? How much does such a standard cost?
8. Through what process of reasoning may we arrive at the conclusion that there is "poverty for many in this land of plenty"?
9. It is believed by many that "conspicuous consumption" arises very largely out of inequalities in income. State the line of argument that appears to lead to this conclusion.
10. Is the purchase of very expensive luxuries by the wealthy beneficial or harmful to the poor? Explain.
11. Cite examples of extravagant expenditure.
12. What can be said for the argument that the conspicuous spending of the rich provides work for those who would otherwise be unemployed?
13. Discuss the consequences of business depressions, as they affect the

[30] *Literary Digest,* September 6, 1930, p. 7.

well-to-do and the wealthy, on the one hand, and the poor, on the other.

14. "Interest and dividends are wholly independent of the health of their recipient, but wages are not." Explain the significance of this statement.
15. "The rich have a better chance than the poor of living to a 'ripe old age.'" Why?
16. Discuss the relationship between economic inequality and educational opportunity.
17. What percentage of the population of the United States is illiterate?
18. Is it not true that anyone who has ability and really wants a college training can get it? Explain.
19. This chapter argues that the poor fare less well than the rich, in so far as legal justice is concerned. Defend or refute this contention.
20. Explain the significance of Mr. Gerard's statement about "the actual rulers of the United States."

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17 ECONOMIC INEQUALITY: CAUSES AND CURES

KEEPING IN MIND THE CONSEQUENCES OF ECONOMIC INEQUALITY, AS OUTLINED IN THE PRECEDING CHAPTER, WE MAY NOW INquire briefly into its causes and then suggest some measures the adoption of which would certainly bring about a larger degree of equality of opportunity than now exists, and might even make life bearable for those who, because of their limited endowments, are unable to "make good" when thrown wholly upon their own resources.

The Causes of Economic Inequality

Differences in Natural Endowments and in Luck.—If we could trace economic inequality to its beginnings, we should doubtless find that it has started, in all instances, either from inequalities in individual abilities or from inequalities in "luck as regards circumstances which it is beyond the power of the individual either to forecast or control."[1] The existence of differences in natural endowments is beyond dispute. Even within the limits of a single family are found variations of such extent that, despite equality of environmental opportunity, one child reaches great heights while another barely escapes mediocrity. No one who has looked into the matter at all carefully is likely to make the mistake of contending that all men are created equal, in the sense of being provided by nature with identical mental and physical capacities.

On the question of luck, there is perhaps more room for argument. Some persons subscribe to the copybook maxim of James A. Garfield that there is no such thing as luck, while others are more inclined to agree with the late Julius Rosenwald, the multimillionaire head of Sears, Roebuck and Company, who once said, "I believe that success is 95 per cent luck and 5 per cent ability."[2] Probably the truth lies somewhere between these two

[1] Josiah Wedgwood, *The Economics of Inheritance*, p. 57.

[2] *New York Times*, January 7, 1932.

extremes. There are certainly some great economic successes that have had in them a large element of luck, chance, or good fortune—call it what you will—while examples are not lacking of achievements that seem to rest chiefly, if not wholly, upon the possession of unique abilities.

Differences in Environment.—But however inequalities may have come about in the first place, there can be no doubt that they have been perpetuated, in many instances, through differences in environment and through inheritance. Americans in particular are prone to advance the argument that persons of ability may be trusted to rise above their environment, no matter how hopelessly situated they may appear to be. The cheerful philosophy that a good man cannot be kept down has been properly and seriously questioned by Professor Hobson, who says:

> The notion that genius, like murder, will "out" is a false sentimentalism. Some men of genius do, indeed, make their way in spite of adverse circumstances, forcing themselves out of the obscurity of their surroundings; they "break their birth's invidious bar, and breast the blows of circumstance, and grasp the skirts of happy chance." That is to say, some sorts of genius are united with qualities of audacity, persistence, and luck, which enable them to win "through." But how many men of genius do not possess these faculties and therefore do not emerge, it is from the nature of the case impossible to learn. But it is probable that much genius, talent, and ability, capable of yielding fine social service, is lost. Indeed, it is probable that many of the finest human variations, involving unusual delicacy of feeling and perhaps of physique, will by natural necessity be incapacitated for making their way and forcing recognition amid uncongenial surroundings.
>
> It is likely that far more human genius is lost than is saved, even in the more civilized nations of today. For what are the conditions of the successful utilization of genius, and for what proportion of the population are they securely attained? Leisure is a first condition for all free and fruitful play of the mind. . . . Education is the next condition. . . . Until all the new minds brought into the world are placed in such free contact with every fertilizing current of thought and feeling, and enjoy free, full opportunities of knowing the best that has been thought and said in all departments of human knowledge, we cannot tell how much creative faculty perishes for lack of necessary nutriment.[3]

[3] J. A Hobson, *Work and Wealth*, pp 51, 52.

Inequalities, then, are passed on from generation to generation because of the environmental differences that result from inequalities. As Professor Pigou puts it: "The environment of one generation *can* produce a lasting effect, because it can affect the environment of future generations. Environments, in short, as well as people, have children."[4] The environment of the well-to-do is conducive to the development of native abilities; the environment of poverty is not. Thus we have a vicious circle, in which economic inequalities lead to inequalities of opportunity, and these in turn give rise to still further inequalities in economic status. "Wealth in modern societies is distributed according to opportunity," writes Mr. Tawney. "And while opportunity depends partly upon talent and energy, it depends still more upon birth, social position, access to education and inherited wealth; in a word, upon property. For talent and energy can create opportunity. But property need only wait for it."[5]

Obviously, the prospects of two boys of equal natural endowments—one the son of a pick-and-shovel man, the other born of wealthy parents—are widely different. The former, as Mr. Tawney suggests, may create opportunity through his heritage of talent and energy, but the latter has opportunity almost thrust upon him. From childhood to manhood, his health is looked after; his schools and college are chosen with care, and tutors are provided if they appear to be necessary; the proper social contacts are developed; and, finally, if he is to take up business or a profession, his father, or other relative, or perhaps a friend of the family, is ready with a suitable opening.

The Influence of Inheritance.—But inequalities are passed on, also, through the institution of inheritance. Indeed, inheritance is believed by most economists to be the chief agent for the perpetuation of economic inequalities. The figures given in Table 22 show clearly that the ownership of property accounts for much of the income received today by the well-to-do and the rich. Through inheritance, this property is handed down from father to son, and the inequalities of today become the inequalities of tomorrow. Professor Taussig, in dealing with the effect of inheritance upon inequality, says: "Its influence is enormous.

[4] A. C Pigou, *The Economics of Welfare,* London, Macmillan & Co, Ltd., 3rd ed., 1929, p. 115

[5] R. H. Tawney, *The Acquisitive Society,* New York, Harcourt, Brace & Company, Inc., 1921, pp. 33, 34.

Obviously, this alone explains the perpetuation of the incomes derived from capital, land, income-yielding property of all sorts, and so explains the great continuing gulf between the haves and the have-nots."[6]

Not only are inequalities continued through inheritance, but in many instances they are vastly increased, since great fortunes have the habit of multiplying. The Astor fortune, started by John Jacob Astor more than a century ago, is a case in point. The 20 millions left by him in 1848, plus a half-million left by Henry Astor, had by 1905 grown to 275 millions, as may be seen by reference to Fig. 3. It is possible, of course, that those

(1848)	J. J. Astor I (d. 1848) left life interest in $20,000,000 to	Henry Astor left $500,000 to
(1875)	W. B. Astor (d. 1875) who left a life interest in $55,000,000	
(1890)	$35,000,000 to J. J. Astor II (d. 1890) who left $75,000,000 to	$20,000,000 to Wm. Astor (d. 1892) who left his estate to
(1905)	W. W. Astor, who had $200,000,000 in 1905	J. J. Astor III, who had $75,000,000 in 1905

FIG. 3.—REPUTED INCREASE IN THE ASTOR WEALTH.[7]

through whose hands this fortune passed added to it not only by saving a part of the interest, dividends, and rents that this great accumulation of property brought them, but by the exercise of their personal abilities as well. But whether true or not, this point does not concern us here. What is important for our purposes is to note that there was no need for the descendants of John Jacob Astor to exert themselves unless they wished to do so. The property at their disposal assured them an income so large that whatever they desired in the way of "the good life"

[6] F. W. Taussig, *Principles of Economics,* New York, The Macmillan Company, 3rd ed., 1921, vol 2, p. 266.

[7] D. E. Bridgman, *An Examination into the Causes of Large Fortunes in This Country,* St Paul, The Pioneer Company, 1909, p. 20.

was theirs for the asking, provided only it was something that could be had for money.

Inherited wealth has a slighter influence upon economic inequality in newly settled countries than in those which have been long exploited, because of the greater opportunity to acquire an income through taking up cheap land, or getting in on the "ground floor" of an industry and "growing up" with it. But this is a stage which passes fairly quickly. On this point Professor Cannan has observed: "As the United States ceases to be a 'new' country, more and more property will be inherited in proportion to that which is acquired in the lifetime of a generation, and there will consequently be more scope for inequality of inheritance. . . . America may be free from inequalities arising from grants of land made by William the Conqueror, but it is just as easy to be the lucky inheritor of a farm which becomes part of the site of a great city there as in England. The Astor inheritance in America has the same source as the Grosvenor inheritance in England, and the Vanderbilt and Morgan millions are no more likely to 'disintegrate' than those of the Rothschilds."[8]

As was suggested in the last sentence of the preceding paragraph, the day has passed when the old adage of "three generations from shirt-sleeves to shirt-sleeves" had some significance. Some of the fortunes of today are so huge that there is no danger of their being dissipated, particularly in view of the recent development and wide use of trust funds. Though invested, in the interest of security, at a very low rate of return, they still provide incomes so large that they cannot be spent without genuine effort on the part of the recipients. Hence it is that the concentration of wealth proceeds apace, and inequalities become progressively greater with the passage of time. It seems fair, therefore, to say that the institution of inheritance is the chief instrument in perpetuating and increasing inequalities. Consequently, any serious attempt to solve the problem of economic inequality must include an attack upon this ancient institution which seems to have largely outlived its usefulness.

Proposed Methods of Distribution

The obvious and glaring inequalities in the distribution of income have led certain socially minded persons to question

[8] Edwin Cannan, *Wealth,* London, P. S. King & Son, Ltd., 1924, pp. 183, 184.

whether the basis on which income is distributed is fair and just. Indeed, some of the doubters have gone so far as to propose substitutes for the principle of distribution—reward on the basis of contributions to the economic process—which seems in general to explain the division of the national income among the owners of the agents of production. We shall examine briefly several of the proposals that have been made.

Equality of Income.—To some people it seems eminently fair that the total income of the country should be divided equally among the adult members of society. Just as we now grant one vote to every citizen of the United States, so would those who advance this theory of distribution give to every citizen an equal share of the total national income.

This arrangement would have the merit of simplicity, and, if we assume that its adoption would not reduce the national income, it would unquestionably do much to improve the economic status of members of the low-income groups, though of course at the expense of the middle classes and the very wealthy. But there are many who hold that distribution on the basis of strict equality would almost certainly mean a much smaller income to divide; for some persons who now labor long, hard, and skillfully, for the sake of personal gain, would be unlikely to exert themselves so strenuously for an individual reward which in no case could be greater than the pay of a lazy, careless, or incompetent worker. As we shall see a little later, in our discussion of economic incentive, this argument is not necessarily conclusive, but it is one which cannot be ignored.

A second objection is that some posts in the economic world today seem to require higher salaries than a bare equality in distribution would provide, if the duties of these positions are to be discharged efficiently. An important executive, whose work involves mental concentration, may need more ample quarters at home as well as in the plant, better means of transportation, and more expensive food and clothing, than the machine-tender who is employed in the same establishment. To some extent these "extras" might conceivably be granted him as a *perquisite of office* and not a *personal wage*; but it is entirely possible that some of an executive's "needs" that must be met, if he is to be of maximum usefulness in production, are so largely personal in nature and so highly subject to sudden change, that they could be cared for only by placing at his disposal a very considerable

fund to be used as he might see fit. And such a fund, of course, would come dangerously close to being a personal wage.

There is the further fact that strict equality in the distribution of income would run counter to the very general feeling in present-day society, that there should be some relationship between a man's contribution to the economic process and the amount of goods he is allowed to have for himself. The familiar saying that a worker should be paid "what he is worth," though it may not stand up well under close inspection, yet suggests the prevalence of the notion that some contribute much to production and others but little, and that each should be paid *in proportion to his contribution.* Public opinion, even if it happens to be mistaken, is a factor that must be reckoned with.

Finally, differences in individual incomes of a given type provide a convenient means of apportioning the agents of production throughout our economic system in such a way as to economize most in the use of the agents which are particularly scarce. Those agents which are very limited in quantity, and at the same time are much in demand, command high prices. A high price is, of course, a very effective warning that the productive agent to which it is attached—say, a given grade of labor—should be used sparingly, and only in those places where a more abundant grade of the agent would not serve. Moreover, a high price for labor, or other agent of production, tends to bring about an increase in the quantity of that factor, and thus to overcome its scarcity. In the absence of differences in wages, some other device would have to be set up to insure the most productive use of labor; and this remark is applicable, also, to the apportionment of land and capital among their several possible uses.

Income According to Need.—Probably the most nearly ideal principle of distribution that has ever been proposed is the payment of income on the basis of need. Few of its critics have ventured to question the desirability of giving to every member of society an income which would enable him to take care of his needs; but, on the other hand, many have risen up to challenge the feasibility of the plan.

It is said, in the first place, that needs are subjective, and that it is impossible to determine—for every man, woman, and child in the country—just what his or her needs are. Wants might be ascertained readily enough, through the simple process of personal inquiry, but probably few persons would hold that a requi-

sition thus drawn up would represent genuine needs and nothing more. However, Professor Hobson[9] and others would insist that, though needs may not be ascertained with absolute accuracy, it is certainly possible for experts in diet, housing, and other fields to determine, within fairly narrow limits, what might be termed the legitimate needs of individual members of society—making allowance, of course, for environmental, occupational, and possibly certain other differences as between individuals.

The payment of income according to need presupposes that everyone would be glad to pitch in and do his share of society's work. Indeed, the slogan in which this principle of distribution is commonly expressed—"from each according to his ability, to each according to his need"—implies that all members of society may be counted upon to contribute generously of their productive power. But it is by no means certain that the principle would work out this way in actual practice. For if all were assured incomes according to their needs, there is at least a possibility that some would not concern themselves greatly about their obligations as producers. Hence, in addition to the difficulty of ascertaining needs, there would be the problem of inducing people to work industriously. Unless this problem could be solved, the national income might not be sufficiently large to meet the needs of society.

Income According to Effort Expended.—To some persons it appears grossly unjust that people who labor long and hard sometimes receive very small pay, while others with short hours and light tasks draw handsome incomes. Would it not be much fairer, they ask, to reward workers on the basis of the effort they expend, giving large incomes to those who exert themselves greatly in production, and small ones to those who work less diligently?

The answer to this query seems to be that society is not, on the whole, interested in having its members work particularly hard, unless by so doing they turn out goods that society wants. Our present method of distribution rewards workers who make goods that are wanted, and pays premiums to those who produce these goods in unusually large quantities. Since what society wants is *goods*, not *toil*, it pays for the former rather than the latter.

This arrangement tends to direct workers into those occupations for which they are best fitted, since it is here that they are best

[9] Cf. J. A. Hobson, *Work and Wealth*, rev ed., 1933, chap. 11.

paid. But if incomes were paid on the basis of energy expended, we might easily have an appallingly large number of misfits in the world of production—those who labored exceedingly hard and were therefore well paid, but who nevertheless turned out—because they were in unsuitable occupations—either an inferior product, or a quantity of product that was excessively small in view of the incomes they received. To adopt this principle of distribution would be equivalent, therefore, to encouraging waste in production. It should be added that it would be exceedingly difficult, if not impossible, to measure accurately the amount of energy expended by every worker in society.

Income According to Social Usefulness.—Yet another proposal is that income should be based upon the *social* usefulness of the service that is rendered. Under our present system of distribution, it sometimes happens that larger incomes may be had by catering to the whims of the wealthy than by taking care of the genuine needs of the masses. For example, it may be more profitable, from the point of view of personal income, to build pleasure yachts for millionaires than to put up dwellings for poorly paid workingmen. But the dwellings would probably far outweigh the yachts, if judged on the basis of social usefulness. Should we not, then, encourage the production of "first things first," by rewarding the producers of necessities more generously than the producers of luxuries?

Possibly so, but the difficulties of administering the principle would seem to be well-nigh insuperable. It would involve not only distinguishing between luxuries and necessities—a very considerable undertaking, since what is a luxury for one person might be a necessity for another—but, in addition, drawing up a list of all economic services that are rendered in a modern civilization, rating them in the order of their social significance, and then deciding upon income differentials which would represent accurately their relative importance to society. This is a task of such dimensions that it is almost inconceivable that it could be performed satisfactorily.

Income According to Productivity.—We must call a halt on our survey of principles of distribution which might possibly be substituted for the one that obtains in most economic societies today. And, though we have not been able to do full justice to the substitute plans that we have outlined, we feel warranted in suggesting that, all in all, payment on the basis of productivity

seems to us to be the best arrangement that has yet been proposed for distributing income—if we assume the existence of an economic order in which competition, self-interest, free enterprise, and private property continue to play important rôles.

We have no desire to suggest that this is an ideal principle of distribution. Indeed, we have gone to some trouble to point out certain of its defects. But, in spite of its imperfections, payment according to individual productivity has advantages which we cannot afford to overlook or underestimate. It helps to stimulate workers to do their best, and thus it tends toward the maximization of national income. And it is, morever, a principle which appeals to most people as fair—for who will contend seriously that a man can rightly claim, as a matter of economic justice, more than he produces, or should be required to accept less? Of course, those who under this system cannot support themselves must be supported by the state—but in the name of common humanity, and not economic justice; and individual incomes, based upon individual productivity, must be taxed so that society may be able to meet this and other legitimate expenses of government.

We are far, then, from proposing an absolute equality of income among the members of our economic order. We believe that the government should undertake to eliminate all anti-social ways of getting income (such, for example, as the exercise of monopoly control, the adulteration of goods, misrepresentation through advertising, and so on), and then encourage every member of society to try to outdo his fellows in *rendering service*—which, as Professor Carver points out, would then be the only means left through which one could hope to get an income.[10] But, as we said at the beginning of Chapter 16, the problem of economic inequality will not be solved until there is equality of opportunity for all members of society, in so far as this can be accomplished through the removal of artificial obstacles to the full development and utilization of personal capacities.

THE CURES FOR ECONOMIC INEQUALITY

The Need for Equality of Opportunity.—From what has been said thus far, it will be seen that we do not hold that the abilities of individual members of society are equal, nor do we believe that it is possible or desirable to attain equality of this kind Furthermore, we do not contend that incomes should be

[10] T N. Carver, *Essays in Social Justice,* chap. 6.

strictly equal, though we believe the gross economic inequalities that exist today are socially undesirable and must be done away with. That is to say, they must be done away with if we are to have the *equality of opportunity* of which we hear so much and see so little. For equality of opportunity, as Mr. Tawney has shown, "obtains in so far as, and only in so far as, each member of a community, whatever his birth, or occupation, or social position, possesses in fact, and not merely in form, equal chances of using to the full his natural endowments of physique, of character, and of intelligence."[11] Mr. Stephen Leacock has the same idea in mind when he insists "that every child of the nation has the right to be clothed and fed and trained irrespective of its parents' lot." "No society is properly organized," he continues, "until every child that is born into it shall have an opportunity in life. Success in life and capacity to live we cannot give. But opportunity we can. We can at least see that the gifts that are laid in the child's cradle by nature are not obliterated by the cruel fortune of the accident of birth; that its brain and body are not stunted by lack of food and air and by the heavy burden of premature toil. . . . If, with all our vast apparatus of machinery and power, we cannot so arrange society that each child has an opportunity in life, it would be better to break the machinery to pieces and return to the woods from which we came."[12]

The Abolition of Inheritance.—Our goal, then, is equality of opportunity such as we have just described. The first move in this direction, we believe, should be the adoption of a thoroughgoing federal estate tax which will prevent the piling up of wealth for the use of individuals, and will insure its expenditure in the interests of all. If this tax is to do its full share in reducing inequalities, it must take a very large proportion of a man's estate upon his death, leaving for the heirs (apart from a modest provision for direct dependents) little more than mere keepsakes, which are valued chiefly for sentimental reasons.

This arrangement would take from the children of the wealthy the advantage that they now enjoy through the inheritance of property which places them economically far in advance of those who have not chosen their parents so shrewdly. There is much to be said for shuffling the cards between every deal, and

[11] R. H. Tawney, *Equality*, p. 125.

[12] Stephen Leacock, *The Unsolved Riddle of Social Justice*, New York, John Lane Company, 1920, pp. 138-140.

for having all runners start from the same point. It is equally important that contestants in the race of life should get an even start, in so far as the elimination of artificial obstacles is concerned. If inheritance of income-producing property were abolished, we should have at last a chance to judge fairly the qualities of the racers—a chance which is non-existent today under a system that often penalizes the weak and favors the strong. It is scarcely necessary to add that an estate tax, if it was not to be evaded, would have to be accompanied by a gift tax which would prevent the transfer of property in anticipation of death, or would at least tax such transfers at a high rate.

Increases in Income Taxes.—In addition to preventing the inequalities of one generation from being passed on to the next, something should be done to reduce inequalities even in the short run. It seems to us entirely fitting and proper that the wealthy—even though they have gained their wealth through their own efforts and not by inheritance—should be asked to pay a very large part of the running expenses of society. We propose, in this connection, an extension of the federal income taxes, with very considerable increases in rates in the high-income brackets.

Just how high these rates should be, we are not prepared to say. This is a matter to be determined by experiment. But there can be no doubt that we are far from having exhausted our possibilities of securing revenue through the agency of income taxation. Surtaxes in the United States reach a maximum of 75 per cent on portions of individual incomes that exceed 5 million dollars—but of these there are, of course, very few. Experience in England and other countries seems to indicate that we might well make substantial increases in the rates that apply to incomes in certain "brackets." Such rates, to be "fair"—that is, in accord with the principle of ability to pay[13]—would have to be steeply graduated, taking only a small percentage of low incomes but a very large percentage of those running into the hundreds of thousands or millions. Moreover, they should be so arranged as to lay a particularly heavy toll upon "unearned" incomes—those derived from the ownership of property—while dealing more gently with wages and salaries, since the latter represent a payment for personal services. To prevent evasion of the income tax, there would be need, of course, to eliminate tax-exempt securities.

The Question of Incentives.—It must not be supposed that

[13] The relative merits of various kinds of taxes are discussed in chap. 8.

a tax program of this kind could be put into effect without meeting considerable opposition. Once it was publicly proposed, prophets would rise up and proclaim that a very high income tax would destroy incentive, while a very high estate tax would both discourage production and lead to wasteful spending. But these are matters about which we know little or nothing from actual experience, so that these prophets, being on uncertain ground, would do well to tread softly. In the past, it is true, we have depended chiefly upon the lure of material gain to induce men to do their utmost in the field of production. But it is entirely possible that, in our worship of material things, we have overlooked other incentives that would prove equally potent, if only we brought them into play.

Indeed, there are many callings—such as the military and diplomatic service, and the so-called professions—in which some non-material incentive, such as the desire for authority or prestige, an interest in the work, or the feeling that this task or that is particularly worth while, appears to be a force sufficient to impel men to pursue their occupations with earnestness and enthusiasm. It seems inevitable that, in a society which to a large extent has eliminated economic inequalities, the economic motive would lose much of its power, giving way to other motives that might prove equally productive of economic goods though less productive of human misery.[14]

But this is clearly a field of speculation, with one man's guess about as good as another's. It may be true that an estate tax such as we have proposed would lessen men's desires to work and thus reduce their productivity, or cause them to spend their accumulations before making their final exit. On the other hand, it is equally possible that our captains of industry and merchant princes are more intent upon establishing reputations as leaders in their respective fields than upon establishing fortunes to be handed down to their descendants. The effect of high income taxes upon production is likewise debatable. Some persons believe that such taxes lessen incentive, while others are equally certain that they increase it. The latter argue that if a business man has set $20,000

[14] Readers who are interested in the question of industrial motives should consult J. A. Hobson, *Incentives in the New Industrial Order,* New York, Thomas Seltzer, 1925, and Paul H. Douglas, "The Reality of Non-Commercial Incentives in Economic Life," in Rexford G. Tugwell, editor, *The Trend of Economics,* New York, Alfred A Knopf, Inc., 1924.

as the amount needed to buy a satisfactory standard of living, the imposition of a 50 per cent income tax might spur him on to greater deeds, since he would then need a gross income of $40,000 in order to have the use of a net income of $20,000, the amount formerly available for spending.

But even if the prophecies of reduced production should be fulfilled, society instead of losing might still be the gainer. For the goal of production is the satisfaction of human wants, and a small volume of economic goods, well distributed, might easily give more satisfaction than a larger volume concentrated in the hands of the few. All in all, then, there is no conclusive evidence that the abolition of inheritance and the heavier taxation of incomes would reduce society's output of commodities and services, or that this reduction, if it should come to pass, would necessarily mean a loss in social welfare.

The Extension of Social Services.—The virtual elimination of income-producing inheritance and an increase in the taxes on large incomes would do much to reduce economic inequality, and at the same time would produce an enormous amount of revenue. To mention specifically but one important item, we may note the fact that the estate tax that we have proposed would, within a century at the most, bring all land (or at least all land used for business purposes) into the hands of the government. This land would doubtless then, as now, be rented out to the highest bidders, and would produce a large and steady income year by year. We believe that estate and income taxation should be made to promote equality not only by relieving the rich of their surpluses, but by bestowing upon the poor the revenue collected in this way. It would doubtless be a mistake to make the distribution on a per capita basis, and in the form of cash. Hence, we propose that it be done in a way that is both simple and sane—through the extension of social services.

We have already advocated[15] the adoption of various forms of social insurance, and the provision of free medical and hospital service for all who need it. Here, surely, is plenty of scope for spending advantageously a considerable part of the revenue of which we are speaking. With the hazards of unemployment, accident, sickness, and old age taken care of, one of the most serious consequences of economic inequality—the worry and hard-

[15] In chaps. 3 and 4.

ship of economic insecurity—would be practically eliminated. Another—the lack of educational opportunity—should be removed through such an expansion of our facilities as would give to every boy and girl, man and woman, as much training as he or she is able to absorb. This educational program, of course, would involve not only free tuition in the elementary and secondary schools, and higher institutions, but also such allowances for living expenses as would make it unnecessary for the members of working-class families to quit school from lack of funds. Our "free" education must be genuinely free, and not a sham! We have already noted the desirability of having public defenders as well as public prosecutors in our system of legal justice. We now go further, and advocate the development of a free legal advising service, provided by the state, from which any person in legal difficulties would be able to secure expert assistance in the conduct of his case; and this assistance must include appeals to the higher courts without cost. Otherwise, there can be no justice worthy of the name.

Conclusion.—It will be recalled that we began our discussion of economic inequality with a plea for a readjustment of social conditions that would insure "equality of opportunity for all members of society, in so far as this can be accomplished through the removal of artificial barriers to the full development and utilization of personal capacities." We have indicated measures through which we might hope to secure a fair degree of equality in the way of economic security, educational opportunity, and legal justice. With an increase in the number and importance of the functions performed by the state through the extension of social services, we should expect our citizens to manifest a greater interest in the control of government than they have shown in the past. This increased interest, combined with a reduction in the economic power of our "big business men," should weaken somewhat the hold that these "actual rulers" have upon the affairs of government. We do not suggest that our proposals for taxation and social services would bring about exact equality in standards of living, though they would unquestionably do much to reduce the present glaring inequalities. And we do believe—and we regard this as the most important item of all—that our program would establish a substantial degree of equality of opportunity, so that such inequalities as continued would be the

result of differences in native endowments and not differences in environmental conditions.[16]

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1. "All men are created equal." Examine this statement critically.
2. Compare the views of James A. Garfield and Julius Rosenwald on the subject of "luck."
3. "The notion that genius, like murder, will 'out' is a false sentimentalism," says Professor Hobson. Comment.
4. What, according to Professor Hobson, are "the conditions of the successful utilization of genius"?
5. Explain the significance of Professor Pigou's statement, "Environments, in short, as well as people, have children."
6. "Talent and energy can create opportunity. But property need only wait for it," says R. H. Tawney. Precisely what does this mean?
7. Professor Taussig says that inheritance "explains the great continuing gulf between the haves and the have-nots." Discuss.
8. Show, by reference to the Astor fortune, the possibilities of increasing wealth through inheritance.
9. Why should inheritance have a slighter influence upon economic inequality in newly settled countries than in older countries?
10. Comment on the significance of the old saying, "It is only three generations from shirt-sleeves to shirt-sleeves."
11. Discuss equality of income as a principle of distribution, stating its advantages and disadvantages.
12. "From each according to his ability, to each according to his need" is a slogan that has been used by certain collectivists. Some people say it would not "work out." What is your opinion, and why?
13. "Those who work hardest should get the largest incomes." Comment.
14. It is suggested in this chapter that the government should under-

[16] The adoption of this program would not, of course, make up for such serious personal deficiencies as physical invalidism or feeble-mindedness. Hence, to repeat a statement made in chap. 4, "it is probable that there will always be some members of society who, because of physical or mental defects, cannot be expected to support themselves. Unfortunates of these kinds will have to be cared for at the public expense, unless they have friends or relatives who are able to look after them adequately." We believe that such persons should be provided with a standard of living that will enable them to live in health and decency, but that they should be prevented from propagating their kind It is often suggested that, if their defects are of a transmissible type, these public charges should be required (in return for their maintenance) to submit to segregation or sterilization, since society cannot afford to have an increase in the numbers of those who, even under conditions of approximate equality of opportunity, are so lacking in ability as to be unable to provide for themselves.

take to eliminate all anti-social ways of getting income. Give examples of income-getting that might be regarded as anti-social.

15. What is the meaning of equality of opportunity, as proposed in this chapter, and why should we seek to attain such equality?
16. What part might taxation play in bringing about equality of opportunity?
17. Might we not destroy economic incentive, if we should undertake seriously to provide equality of opportunity for all? Explain.
18. Distinguish between "economic inequality" and "economic insecurity."
19. Examine carefully the implications of the term "free education."
20. Even though perfect equality of opportunity should be attained, there would still be some members of society who were unable, because of personal shortcomings, to earn a satisfactory living for themselves. What should society do about such persons?

References for Further Reading

See list of references at the end of Chapter 16.

PROBLEMS OF GOVERNMENTAL CONTROL

18 MONOPOLIES AND TRUSTS

FROM THE STUDY OF ECONOMIC PRINCIPLES WE LEARN THAT IN MANY INDUSTRIES, THOUGH NOT IN ALL, ECONOMIES MAY BE brought about through large-scale production. But even in the fields where the economies of large-scale production are great, a single firm may grow to a size beyond which no economies in actual operation of the plant would result from a further increase in size—although a larger size might be desirable from the point of view of efficient marketing of the product, economical financing of the business, or bearing the risks of the business. Under such conditions, it often happens that several business plants are brought under one central control, so that all may be operated as a single business unit, though each plant is limited to the size at which it can produce most efficiently.

But the process of centralization of control has not always stopped here. Sometimes one firm, or a combination of firms, has increased in size until it controlled so large a part of the capacity of a whole industry that it could regulate the output of the industry sufficiently to exercise control over the price charged for its product. Such a business organization, whether it achieved complete or only partial monopoly, has usually been called a "trust."

Combinations and Trusts.—At the outset of our discussion, we should distinguish between trusts and ordinary business combinations. A business combination, whether horizontal or vertical, may be formed in any industry without a trust resulting, so long as the combination controls only a relatively small part of the total output of the industry. On the other hand, a trust may arise through the growth of a single firm, through a trade association of several otherwise independent firms, or through the almost unconscious cooperation of large firms under conditions of monopolistic competition, without actual combinations of business units taking place.

In speaking of trust conditions, therefore, we shall have in mind

a person, firm, combination of firms, or a formal or informal association of firms, which owns or controls sufficient productive capacity of an industry to enable it to control the price or prices charged by the whole industry or business for its product or products. It is not possible to say exactly what percentage of the productive capacity of an industry must be controlled in order to fix prices, for the percentage would vary considerably from one industry to another; but it is certain that trust powers can often be exercised by an organization which controls far less than 100 per cent of the capacity of an industry.

We are not including, in the present discussion, all industries in which some degree of monopolistic power is exercised. Public utilities, such as water, gas, and electric companies, will be treated in a later chapter. These public utilities have long been recognized as "natural monopolies," that is, as businesses which can attain maximum efficiency only if given monopoly control and which, if organized competitively, would eventually turn into monopolies. Hence, public utilities have usually been permitted to operate as monopolies under governmental regulation. The railroads, which will also be discussed separately, are more like public utilities than like ordinary industrial trusts and have been accorded special treatment by the federal government. Finally, while the development of trust conditions in industry has often been stimulated by patents and other legally granted monopoly powers, we shall not discuss concerns which have become monopolies exclusively through such legal grants. With these exceptions, we shall deal in this chapter with all types of business organizations which enjoy trust powers in industry and trade.

The Development of the Trust Problem

The Types of Trust Organization.—For many years, the existence of trust conditions in an industry usually meant that the field was dominated by a single large firm or by a gigantic formal combination of firms. Though trusts in this sense existed in the United States as early as the middle of the nineteenth century, the most active period in their organization was from 1887 to 1903. They took many forms, some of which we shall describe briefly.

The Pool.—One of the earliest types of trust organization was the pool, which consisted of a group of firms combined for certain purposes, although they remained independent in other respects.

As to method of operation, pools were of several types, of which we shall note three. In the pool designed to regulate output, the various member firms would agree upon the total output to be produced and the percentage of the total to be allotted to each member. Thus, through restriction of output, prices would be controlled indirectly. In a second type of pool, the member firms would divide up the entire market area among themselves, each firm having a monopoly of its own area. Finally, there were "profits pools," by means of which the net earnings of all the firms, obtained by selling their product through a common agency, would be divided among the members according to a prearranged ratio.

Pools, in general, were not a very successful type of trust. Soon after a pool was formed, the individual members, or some of them, usually succumbed to the temptation to make a little money on the side by violating the pool agreement. This often meant the end of the pool; for the agreement among the firms was not enforceable at common law, since it was an agreement in restraint of trade.

The Trustee Device.—Another form of trust organization was the trustee device. The stockholders of the combining corporations would assign their stock with voting power to a board of trustees, and receive in return trust certificates representing the value of their properties. By holding a majority of the voting stock of the various companies, the board of trustees could elect the officers of these companies and control them as a unit with respect to production and prices. The board of trustees would collect dividends on the securities held in trust, and distribute them among the owners of the trust certificates.

The trustee device was attacked in the courts of several states and was declared illegal, both as tending to create monopolies and as an unauthorized activity on the part of the individual corporations. The Standard Oil Trust, first organized in 1879, was an outstanding example of the use of the trustee device.

The Holding Company.—A type of organization which has endured down to the present time is the holding company. This is a corporation which exists for the purpose of owning and controlling the securities of other corporations. With its own securities, or with cash, it buys up at least a majority of the voting stock of the corporations which are to be combined, and thus is able to control their management, output and prices. The hold-

ing company is very similar to the old trustee device, the securities of the holding company taking the place of the trust certificates and the board of directors of the holding company superseding the board of trustees. However, since many states have passed laws authorizing the existence of holding companies, this device is not automatically illegal, as was the old trustee device. There are also holding companies which hold only small percentages of the securities of other corporations, but these do not concern us in our study of the trust problem.

The Merger.—The merger is somewhat similar to the holding company. While the holding company controls several business firms through security ownership, the merger exercises the same control through holding the physical properties of the various firms. In some instances, several corporations lose their identity in a new corporation which is organized to manage all the properties of the old firms. In other cases, one of the old corporations remains in existence, and the others are merged in it. Like the holding companies, mergers are not illegal in and of themselves.

"Monopolistic Competition."—In recent years, trust conditions have appeared in many industries which are not dominated by a single large firm or a formal combination of firms. In such industries, a large part of the total productive capacity is controlled by a small number of large firms which do not, to any great extent, compete with one another as regards price. All sell their goods at about the same prices and compete on the basis of quality, trying to attract and hold customers through extensive advertising and other devices. Firms in industries such as these do not decide to produce a certain volume of goods and then to accept whatever price this quantity will bring on the market. Rather, they decide in advance what their selling price is to be, and limit their output to the quantity that will sell at these prices. They make their profits in prosperous times by selling more of their products than formerly at prices which have not been raised extensively; and they take their losses, when necessary, by selling only small quantities of goods at prices which are not lowered greatly. Such industries are often described as operating under conditions of "monopolistic competition."

The cement industry is commonly said to be an industry of this type. In 1929, five large companies controlled 59 out of a total of 175 plants, or 40 per cent of the total capacity of the industry. Of the 72 other companies in the industry, operating in

all 116 plants, no one central office controlled more than 3½ per cent of the total capacity of the industry. The cement industry operated at 28 per cent of capacity in 1932, 29 per cent in 1935, and 76 per cent in 1936, but prices in the great depression following 1929 got no lower than 77 per cent of the 1926 prices.

Trade Associations.—The firms in the cement industry, as in many other industries, cooperate with one another through a trade association, which is a voluntary, mutual benefit association having as its members the various business firms in a certain trade or industry. Trade associations have many legitimate fields of activity, such as dealing with the problems of cooperative advertising, management, improvement of products, new markets, and sales methods; and some associations gather and disseminate among their members information concerning various trade conditions, such as production, stocks, and prices. Sometimes, however, the information disseminated and the rules governing the members are such that the trade association becomes a vehicle for the development of monopoly powers.

Basing-point Systems.—In the cement industry a system of "delivered prices" is maintained by the firms through their trade association by using some 69 "basing points." All mills in a given basing-point district charge customers a uniform base price, plus freight from the basing point to the customer's geographical location. Frequently the actual freight rate from seller to customer will be less than that from the basing point to the customer, and the difference goes into the seller's profit. Mills located outside a given basing-point district must charge the same prices as those inside the district, when making sales in that district, and absorb the higher freight charges as best they can. Thus, a customer in a given district would be quoted the same price for cement by all mills in the district, and by mills outside the district as well, so that price competition is eliminated.

Other Pricing Systems.—In some other industries, uniform delivered prices are maintained, all customers in an entire section of the country being charged the same price regardless of their location with respect to the point at which the goods are produced. In still other cases, the firms in an industry may agree to charge uniform prices at their plants, but require customers to pay the varying costs of delivery. The effect of this system is to divide the country into local areas, with each firm having almost com-

plete control of sales near at hand but perhaps competing with other concerns for customers who are about equidistant from several producers.

However, trust conditions resulting from monopolistic competition do not depend upon an organized pricing system for their existence. When an industry is dominated by a few large firms, each of which has heavy fixed costs, price-cutting is an extremely dangerous practice, especially if consumers can readily postpone their purchases of the goods. Each of the large companies knows that a price-cut on its part would be swiftly followed by similar cuts by other large competitors, to the detriment of all companies concerned—and so prices tend to be maintained by the large companies. The numerous small companies which may exist in the same industry usually follow faithfully the price leadership of the larger companies, either because they fear reprisals if they cut prices or from a belief that their economic welfare will be enhanced by following the leaders. In such industries, price changes seldom occur, and when they do occur are introduced by all the firms at about the same time.

Conditions roughly similar to those in cement manufacture exist in many other industries. About 90 per cent of sulphur production is in the hands of two large companies, and the price of this commodity has not changed since 1926! In automobile production there are three, in the production of farm equipment four, in cigarette production four, and in gasoline production also only a few large companies. In contrast with such conditions, let us consider briefly an industry in which monopolistic competition is said not to exist, such as the cotton textile industry. In this industry, there were in 1929 some 800 corporations operating a total of about 1000 mills, with no single producer controlling more than 3 per cent of the total productive capacity of the industry. Each operator was too small to control prices, and ordinarily turned out a considerable volume of product, even in times of depression, as long as selling prices were sufficiently high to cover operating costs and at least a part of the fixed costs of the business. Production fell only from 95 per cent of capacity in 1926 to 80 per cent in 1932, and was back to 91 per cent by 1935. Prices in 1932 were at 54 per cent of the 1926 level. Net profits of $76,-000,000 in 1927 were replaced by net losses of $92,000,000 in 1930. The points of difference between such an industry and in-

dustries in the field of monopolistic competition stand out very clearly.[1]

The Public Attitude Toward Trusts.—The attitude of most people toward the trusts has for many years been one of acute distrust and opposition. Though not all trusts have been successful, many have been highly so, and in most of these cases the reason for success seems almost always to have been their power over production and prices, rather than any unusual economies in operation or the elimination of waste. The advantages of large-scale production are many and well known, but most of them reach a limit rather quickly and do not go on increasing indefinitely as a firm grows in size. Monopoly control is not required in order to reap these advantages. Other advantages, not available to a single large-scale firm, may be enjoyed by certain types of business combination. They may avoid competitive duplication of plant, and of advertising and selling effort. They can eliminate a large number of competing brands and avoid "cross-hauling" by filling each order from the nearest plant. When a period of poor business hits an ordinary industry, it may be necessary for all the plants to run at part capacity, and thus run inefficiently. A combination, however, can close some plants completely and keep others running efficiently at full capacity.

The several plants controlled by a combination may be made to specialize in different phases of its production, and rivalry between plants may be used as a stimulus to greater efficiency. Finally, any new processes or machines which are owned by any one of the firms may be used by all when all are members of a combination, whereas otherwise each plant would usually have its own trade secrets and special methods, and no one plant would have access to all of the best methods of production. This list of advantages, though not necessarily exhaustive, is imposing; but a few moments' reflection will convince the reader that a business combination need not be a trust in order to enjoy these advantages. Little statistical evidence is available as to the costs of production of trusts, but the little that we have suggests that these costs are very seldom much lower than the costs of independent large-scale concerns, or of combinations which lack trust powers.

Monopoly Prices.—In view of the fact that trusts may claim but few, if any, economies as distinctively their own, it is evi-

[1] This information about the cement and cotton textile industries is taken largely from *Fortune*, March, 1938, pp. 75-77, *et seq.*

dent that their success has almost always been due to restricting output and charging monopoly prices. The result has been large profits at the expense of the consumers. When a trust has had a complete monopoly in an industry, it has usually considered its price policy to be strictly its own affair, a matter to be determined on the basis of self-interest. When a trust has held only a partial monopoly, it has often undertaken to dictate to other firms in the industry. Often these firms could be made to see the light. The knowledge of what happened to small firms in other industries because of their opposition to trusts has usually convinced possible competitors of the wisdom of charging the same prices as those set by the trust, and of refraining from increasing output unless this should be permitted by the trust. When smaller firms have not cooperated and have persisted in offering vigorous competition to the trust, they have almost invariably come to grief.

We shall examine later the methods used by some trusts to achieve and maintain "order" in an industry. For the present, we merely note that in the end the successful trust has almost always gained control of prices throughout the industry and reaped considerable profits as the result. It is difficult to determine the exact effect of trust control upon prices. To do this, we should have to compare the prices charged by the trust with those which would have prevailed under competitive conditions. Since there is no way to determine the prices which would have prevailed if the trust had not been formed, this comparison cannot be made. We know, however, that the prices charged under trust conditions have usually been sufficiently high to yield large profits to the trusts.

It is true, as some defenders of trusts have said, that prices in certain industries controlled by trusts have been stable or have even declined at times, but it should be remembered that monopoly profits may be gained without price increases. A stable price will yield large profits if it is high enough in the first place, or if it is accompanied, over a period of time, by falling costs of production. Even a falling price over a period of time will be highly profitable if costs fall even more rapidly.

The profits made by trusts are themselves a fair indication of the effect of trust control upon prices. For example, the Aluminum Company of America, a trust with almost complete monopoly control, had aggregate earnings of over $119,000,000 in the period

from 1906 to 1921. This was a total earning of 1487 per cent on the original investment, or nearly 100 per cent a year during this period. From 1890 to 1908, the American Tobacco Company averaged 34.5 per cent a year earnings on its investment. The old Standard Oil Company, in several years, paid dividends of approximately 100 per cent on its stock, and from 1920 to 1927 the thirty known successors of the original company made an average annual return of 74 per cent on the 1912 investment.[2] Such profits can be made only from prices which are set well above the cost of production level, whatever may happen to the absolute level of the prices. From the point of view of society, then, the principal objection to the trusts is the effect of trust control on prices and the burden thus placed upon the consumers of trust products.

Unfair Tactics of Trusts.—When the smaller firms in an industry have refused to cooperate with trusts, or when new competition has sprung up, the trusts have often resorted to unfair tactics in order to attain their ends. These unfair practices are so numerous that several chapters might be devoted to describing them, but we shall note only a few. Trusts with large or national markets have often resorted to local price-cutting. That is, in areas in which they have had competition, they have cut prices to the cost level, or even below cost if necessary, in order to force their competitors to take large losses. Meanwhile the trusts themselves have been able to "break even" or make money by continuing to charge high prices in non-competitive areas. The Standard Oil Company was a notorious follower of this policy of "cutthroat competition," but there were also many others.

Trusts that controlled a tremendous volume of business were once able, by playing one railroad against another, to secure rebates on freight rates, or to induce the railroads to establish particularly favorable rates out of the cities from which the trusts shipped most of their products. The Standard Oil Company once made an arrangement whereby the trust not only received a substantial rebate on its own shipments, but also received a similar sum from the freight payments made by competitors. The unfairness of such a policy is apparent.

Trusts have sometimes ordered dealers selling their products to refrain from handling the products of competing companies, thus limiting the market open to competitors. The International Har-

[2] Roy E. Curtis, *The Trusts and Economic Control,* New York, McGraw-Hill Book Company, Inc., 1931, pp. 352-355.

vester Company, among others, used these "exclusive dealer agreements." A similar device was the "tying contract." The United Shoe Machinery Company, for example, leased indispensable machines on which it held patents, but required the lessee to contract also for the use of other machines on which the patents had expired, and which were offered by other firms at lower figures. In this way, the trust forced shoe manufacturers to use its machinery exclusively, and thus destroyed competition.

Sometimes trusts have interfered with the flow of services and supplies needed by their competitors. They have persuaded or forced banks to cut off credit, and to call in the loans of competing firms, and have led newspapers and periodicals to refuse competitive advertising. Railroads have been induced to delay shipments or to develop sudden "shortages" of freight cars of the necessary type; and sellers of raw materials have been persuaded not to fill the orders of competitors, or to fill them with inferior materials or only after long delay.

When public feeling against the trusts has run high, they have often made it appear that firms under their control were independent. Those who might refuse to deal with the trust would buy from these "bogus independents," and these companies could compete with the genuine independents without their fraudulent nature becoming known. Many trusts have brought spurious law suits against competitors, charging patent infringement or other injury. These suits would often tie up the business of the competitors and involve them in heavy legal costs, even though the suits were eventually dismissed. Competitors have sometimes been intimidated by the mere threat of such suits. On the other hand, trusts have infringed upon the patent rights of competitors or appropriated trade secrets gained through espionage or bribery, confident that they would make more through such illegitimate acts than any amounts which the courts might award the competitors by way of damages. Customers of competitors have been bribed to cancel orders or to default on payments, while valuable employees have been bribed to leave the employ of competitors.

Finally, trusts have often sought to damage their competitors' products or reputations. For instance, the National Cash Register Company is said to have "doctored" machines made by competitors, so that they would break down or fail to work satisfactorily. The same company bought up competitors' machines from their

users and offered them for resale, displaying them as "junk" or as "inferior products at 30 cents on the dollar."

Political Influence of the Trusts.—The effect of monopoly control on prices and the unfair methods employed against competitors are not society's only grounds for complaint against the trusts, for the trusts have also been guilty of exercising undue political influence. By contributing heavily to political war chests and receiving favors in return, or by the more primitive methods of bribery and intimidation, trusts have sometimes succeeded in getting favorable legislation passed or having unfavorable legislation killed. The importance of such political influence is great. Indeed, the survival of several trusts has depended upon the maintenance of protective tariffs, which have been raised from time to time by accommodating legislators and have prevented effective competition from goods produced more advantageously in foreign countries. And it is even charged that trusts have had judges on their payroll, as a safeguard against harm if lawsuits against them should chance to be tried in certain courts.

The Trusts and Business Cycles.—Trusts have also been charged with increasing the instability of our economic system. In periods of good business, as we have already noted, they maintain stable prices for their products in the face of increasing production and falling costs, and without increasing the wages of labor. Such policies, in spite of all that can be done to support consumption through installment selling or other credit devices, lead eventually to business breakdown and depression. And in periods of depression, the trusts are likely to hold their prices at the customary level, taking losses by selling fewer units at the "stable" price rather than by selling more at a lower price. This policy results in laying off labor and reducing consumer purchasing power, which eventually affects all industries and adds to the cumulative downward spiral of depression. Some economists hold that cyclical swings in business can never be eliminated, or even greatly reduced in severity, so long as many of our most important industries are controlled by complete or partial monopolies with their rigid or "sticky" prices.

The Trusts and Economic Progress.—Finally, the trusts may also operate as a bar to economic progress. Secure in their monopoly or semi-monopoly position, they need not worry about developing new methods and processes or making new inventions, for their profits do not depend upon continuous progress in

production. Indeed, they may even go to the other extreme and acquire control of new inventions by fair means or foul, only to put them on the shelf for a long time so that they may not overturn existing conditions in the industry.

Attempted Solutions of the Trust Problem

Checks on Trust Powers.—Even in the absence of governmental interference, the effects of trust control are not always so bad as they are painted. A trust must exercise care as to how high a price it charges, or it may cause customers to turn to substitute products, or competition to develop in the form of new firms attracted by large profits. Trusts may conceivably moderate their policies because of anxiety not to stir up public opinion, or because of a sense of justice or fairness on the part of their management. Even more likely, the management of a trust may become stagnant or inert, and fail to take full advantage of its powers and opportunities. Finally, even if a trust is determined to exploit the public to the utmost, it may not be possible to determine the exact price which will bring in the greatest possible total net return.

However, the people of the United States, with their strong hatred of monopolies and trusts, have not been willing to depend upon the semi-automatic forces described above to restrain the trusts in the use of their powers. Since the trust movement constitutes a problem which is national in character, we have demanded federal legislation dealing with trust abuses. The basic American anti-trust law, the Sherman Anti-Trust Act, was passed in 1890, shortly after the start of trust organization but before the most active years of trust development.

The Sherman Anti-Trust Act.—The Sherman Anti-Trust Act was a rather brief, though important, document. It declared illegal all contracts, combinations of business firms, and conspiracies, in restraint of interstate or foreign commerce. It made guilty of a misdemeanor every person who monopolized, attempted to monopolize, or combined or conspired with any other person or persons to monopolize, any part of the trade or commerce among the states or with foreign nations. It declared illegal all contracts, combinations, and conspiracies in restraint of trade in a territory of the United States, in the District of Columbia, or between either of these and any state, states, or foreign nations.

The term "person" as used in the Act was defined as including corporations and associations.

Penalties for the violation of these provisions were set at a fine not exceeding five thousand dollars, or imprisonment not exceeding one year, or both. Persons suffering damages as the result of violations of the Act could sue the guilty parties in the federal courts and recover triple damages, plus costs. The circuit courts of the United States were given authority to prevent and restrain violations, by injunction or otherwise, upon petition of the district attorneys and after hearings had been held. These courts were empowered to summon witnesses from any part of the country. The property of any violator, intercepted in the course of interstate or foreign commerce, was declared forfeited to the United States.

Enforcement of the Sherman Act.—At first glance it would seem that Congress, in passing the Sherman Act, had forged a powerful weapon with which to deal with the trusts. However, the Sherman Act was quite ineffectual for many years, and the period of most rapid trust formation—1897 to 1903—occurred after its enactment. This early ineffectiveness of the Act was attributable to several causes, including uncertainty of the exact meaning of certain parts of the law, lack of funds with which to enforce it, the apathy and incompetence of the attorney-generals and their subordinates which led to poorly drawn indictments and inexpert pleading of cases, and the lack of public support. In 1895, an important case involving the sugar trust, United States *vs.* E. C. Knight Company, was decided in favor of the trust in such manner as to throw doubt upon the federal government's power to deal with the trusts. The Supreme Court held that the government had proved only the concentration of industrial control in the industry and not restraint of interstate or foreign commerce.

A few years later, two decisions favorable to the government put new life into the Sherman Act. In 1899, the Supreme Court unanimously upheld the decision of the Circuit Court of Appeals dissolving the pool between the Addyston Pipe and Steel Company and five other corporations, all engaged in the manufacture of cast-iron pipe, and enjoining the pool members perpetually from carrying out their agreement. In 1904, the Northern Securities Company case decided definitely that the Sherman Act applied to holding companies, whenever these companies operated

to restrain interstate or foreign commerce. The Northern Securities Company, by giving its own securities in exchange, had acquired almost complete control of the Northern Pacific and Great Northern Railroads, and would have operated to eliminate competition between these two roads.

These two decisions encouraged the government to bring further suits against the trusts, and discouraged the formation of additional trusts. The next few years, under President Theodore Roosevelt, were filled with vigorous "trust-busting" activity on the part of the government.

The Rule of Reason.—In the trust cases involving the Standard Oil Company of New Jersey and the American Tobacco Company, both of which were decided by the Supreme Court in 1911, the Court developed the now famous "rule of reason" for deciding trust cases. Although the Court had thrice decided that the Sherman Act applied to *all* contracts, combinations, and conspiracies in restraint of interstate or foreign commerce, it now held that the Act was meant to apply only to "unreasonable restraints" on such commerce.

The Court suggested that the Sherman Act had been worded so strictly because of the many new types of contracts and combinations which were being developed, and the desire of the framers to see to it that no trust escaped merely because of the form in which it was organized. The contracts, or other acts, prohibited in the law were not explicitly defined and the classes of acts prohibited were so broad that almost any activities of business men might come under the influence of the Act under certain conditions. Thus, it was held, the use of reason became indispensable in deciding whether particular business activities had or had not brought about the wrongs which the statute prohibited.

As Justice Brandeis put it in 1918, in the case of the Board of Trade of the City of Chicago, *et al., vs.* the United States: "Every agreement concerning trade, every regulation of trade restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." In spite of the development of the rule of reason, the Supreme Court decided that both the Standard Oil Company and the American Tobacco Company were operating in violation of the Sherman

Act, and they were ordered to dissolve within a reasonable period of time. Later on, however, under the interpretation of the rule of reason, a government case against the United States Steel Corporation was decided in favor of that company.

The Clayton Act.—Because the Sherman Act was not wholly successful in carrying out the purposes of its framers and because there was need for further clarification of its provisions, two additional laws were passed by Congress in 1914. The first of these, the Clayton Act, with certain qualifications, prohibited local price discrimination and the use of tying contracts. Because of the popularity of the holding company device, the Act specifically provided that holding companies were illegal if their effect was to lessen competition substantially in any industry, to restrain commerce in any section or community, or to create a monopoly in any line of commerce. It was also provided that, after 1916, no person should be at the same time a director of two or more corporations engaged in commerce, other than banks and common carriers, any one of which had a capital, surplus, and undivided profits of more than $1,000,000, if such corporations were, or had been, competitors, so that the elimination, by agreement, of competition between the firms would constitute a violation of the anti-trust laws.

Violations of the anti-trust laws by corporations were thereafter to be considered as violations by the directors or other officers who were responsible for the illegal activities, and these officials were to be subject to the penal provisions of the anti-trust laws. Labor organizations and certain types of agricultural associations were exempted from the provisions of the anti-trust laws. Responsibility for the enforcement of these laws was vested in the Federal Trade Commission for industrial combinations, the Federal Reserve Board for financial institutions, and the Interstate Commerce Commission for combinations in transportation. The Clayton Act constituted an addition to, rather than a change in, the anti-trust law as set up in the Sherman Act, for government suits against trusts continued to be brought under the Sherman Act. The Clayton Act was also intended to be a preventive measure in connection with trust formation rather than, as in the case of the Sherman Act, a cure for trusts after they had been formed.

The Federal Trade Commission Act.—A commission of five members, appointed by the President, for the administrative

regulation of business conduct was created by the Federal Trade Commission Act, which like the Clayton Act was passed in 1914. The principal powers of the Federal Trade Commission were (1) the investigation, and (2) the prevention, of unfair competition.

In the field of investigation, the Commission was empowered to gather and compile information concerning the organization, business conduct, practices, and management of any corporation engaged in commerce, except banks and common carriers, and to require such corporations to make regular or special reports, or to answer specific questions. It could, upon request of the President or either house of Congress, investigate and report the facts concerning alleged violations of the anti-trust acts by any corporation. When requested by the Attorney-General, it could investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the anti-trust laws, and, when requested by the court, could ascertain and report an appropriate form of decree in any suit in equity under the anti-trust laws, and investigate the manner in which any final decree in an anti-trust case had been or was being carried out. It could make public, from time to time, such portions of its information as it deemed expedient in the public interest.

With regard to conditions of competition, the Act declared that unfair methods of competition in commerce were unlawful, and the Commission was directed to prevent persons and firms from using such unfair methods. The Act did not specify what were or were not unfair methods of competition, so that the Commission was granted a wide territory within which to exercise its judgment. If the Commission had reason to believe that a person or firm was using unfair methods, it could serve a complaint, stating its charges and providing for a hearing. After the hearing, if the charges proved to be true, the Commission could order the person or firm to stop employing its objectionable methods. If the order was not obeyed, the Commission could apply to the circuit court of appeals of the district for the enforcement of the order. Once this point was reached, the court had full jurisdiction over the case and could affirm, modify, or set aside the order of the Commission. Appeals could be taken to the Supreme Court.

The Work of the Federal Trade Commission.—In general, the Federal Trade Commission has been quite successful in carry-

ing out its manifold duties. It is sometimes said, however, that most of the work of the Commission with respect to unfair competition has concerned ordinary business men and firms rather than trusts. Most of the unfair practices of the trusts had already been specifically prohibited by legislation, or had been adjudged illegal in previous court decisions, so that of recent years most of the unfair methods have been employed by small firms against one another or against the large firms, rather than by the trusts against small competitors.

The more recent lists of unfair competitive practices cited by the Commission include such items as (1) sales of rebuilt articles as new, (2) harassing competitors by requests for catalogues and estimates, (3) giving and offering to give premiums of unequal value, the particular premiums received to be determined by lot or chance, (4) advertising articles for sale at "slashed prices" while in reality usual prices were charged, (5) false claims of "no extra charge for credit," and (6) advertising articles for sale "Direct from Factory to You," when in fact the seller obtained his supplies from any source available and owned no factory whatsoever. These are, of course, but a few of hundreds of such practices. The Commission is also active in preventing the use of unfair practices of the types that used to be popular with the old trusts.

While much of the work of the Commission has had to do with matters which are not essentially trust practices, too much emphasis on this point might make us underestimate the preventive influence which it exerts. No one knows how bad trust conditions might be at present, had the Federal Trade Commission never been set up. Many trusts have probably modified their business practices in view of the powers granted the Commission in the control of unfair methods. Since unfair practices often gave trusts their start, or at least were of considerable aid during their formative period, it is probable that the organization of some trusts has been prevented by the work of the Commission. Though the Commission has been hampered at times by the restrictive decisions of the Supreme Court, and by the tendency of that court to perform all over again work which had already been done by, and was the proper function of, the Federal Trade Commission, it is generally conceded that the Commission has acquitted itself creditably.

The Federal Trade Commission has also been able to accom-

plish much in the way of eliminating unfair competition through voluntary cooperation on the part of business men. It has encouraged trade practice conferences, with the representatives of an industry assembling, either on their own initiative or at the request of the Commission, but in either case under the auspices of the Commission, to discuss fair and unfair practices in the industry and provide for the elimination of the unfair methods with the cooperation and support of the Commission. This method has the advantage of dealing with a whole industry at one time, and permits business men to appear as friends of the Commission rather than as accused persons. The conference method has grown so rapidly in favor that in 1926 the Commission found it necessary to set up a Division of Trade Practice Conferences to expedite this work.

Minor Changes in the Anti-trust Laws.—During the period from 1914 to 1929, several minor changes were made in the application of the anti-trust laws. The Shipping Act of 1916 legalized agreements between steamship lines with regard to fixing rates, apportioning traffic, and other matters, subject to the approval of the Shipping Board. The Packers and Stockyards Act of 1921 classified packers, commission merchants, and stockyards for special regulation under the supervision of the Secretary of Agriculture. The Webb-Pomerene Act of 1918 legalized agreements and associations entered into for the sole purpose of engaging in export trade, or holding company arrangements for the same purpose, providing that restraint of trade within the United States did not result. The Capper-Volstead Act of 1922 legalized the organization of cooperative associations of agricultural producers, provided they operated for the mutual benefit of members, did not handle products of non-members to an amount greater in value than those handled for members, and either allowed no member more than one vote or paid no dividends on stock or membership capital in excess of 8 per cent a year.

The N.R.A. and the Anti-trust Laws.—As the post-1929 depression wore on, an increasing volume of opposition to anti-trust laws developed among business men. It was held that business instability was bound to prevail so long as business firms in an industry were not permitted to cooperate with respect to industrial capacity, output, and prices, without being subject to prosecution under the anti-trust laws. Moreover, it was claimed

that unfair methods had not been eliminated and that, under the influence of the depression, they had become more intolerable than ever.

These complaints led to the passage, in 1933, of the National Industrial Recovery Act, which authorized trade associations or other organizations of business men to draw up "codes of fair competition" for their respective industries and submit them to the government authorities for approval. These codes, after being examined at hearings attended by representatives of labor and consumers, as well as government officials, were submitted to the President and, if approved by him, thereupon constituted the laws of business conduct for the respective industries. The codes affected all firms in an industry regardless of whether they had or had not been parties to their formation.

Not only were the codes expected to enforce fair practices in the industries, but it was understood, also, that business firms would not be prosecuted under the anti-trust laws for activities which were approved under the codes. In return for these concessions to business men, the latter were required to make the codes acceptable to the government with respect to child labor, collective bargaining for employees, and maximum hours and minimum wages for their workers.

The general success, or lack of success, of the N R.A. is discussed in a later chapter. For the present, it is sufficient to note that the codes of fair competition were rushed through and approved very hastily, so that many of them contained provisions which encouraged the further development of monopoly conditions in the industries, under the suspension of the anti-trust laws. About one-half of the codes included the so-called "open-price" requirement, which compelled every firm in an industry to file its list of prices with the code authority, and to give advance notice of proposed price changes. This provision seemed innocent enough on the surface. But since a firm had to give advance notice of intended price changes, its competitors had a chance to threaten it with reprisals and in this way could often prevent projected reductions from taking place.

About three-fourths of the codes provided that no sales should take place at prices below "cost." Some forty codes set limits upon the number of hours per week during which the machines and factories in the industries could operate. Under about the same number of codes, the code authorities were empowered to

prevent the entrance of new capital into their industries, subject to some supervision by the government. Finally, there were codes that went so far as to permit the use of the "basing-point system," charging customers with non-existent freight costs on goods which were not shipped from the basing point.[3]

The code system practically compelled the producers in an industry to combine, so that it is not surprising that the N.R.A. gave a strong impetus to the growth of trust powers in many industries and interfered seriously with the traditional governmental policy toward the trusts.

The Robinson-Patman Amendment.—Two other recent pieces of legislation will undoubtedly have an effect upon the trust problem, although it is too early to know definitely what their influence will be. One of these laws is the Robinson-Patman Amendment to the Clayton Act. The prohibition of price discrimination by the Clayton Act was concerned chiefly with the effects of such discrimination upon the competitors of the offending company. But price discrimination may have important effects upon the different buyers and their customers, and the Robinson-Patman Amendment seeks to broaden and clarify the provisions of the Clayton Act on this point.

The amendment applies to concerns which sell any part of their products in interstate commerce at prices that are discriminatory with respect to prices charged within the state. It prohibits price discrimination among buyers whenever the result of such discrimination would be to lessen competition substantially between any buyer and the discriminating firm, between the more favored and the less favored buyers, or between the customers of those buyers. In the past, it has been common for manufacturers to market part of their products at regular prices, and to sell the remainder to mail-order houses, chain stores, or department stores at low prices for sale under a different name; or to discriminate for or against these types of marketing agencies, as compared with ordinary wholesalers, jobbers, and retailers. Any such discriminations, which cannot be justified on the basis of differences in costs resulting from variations in the quantities sold or the methods of sale or delivery, are forbidden under the Robinson-Patman Amendment.

[3] Cf. Paul H. Douglas, *Controlling Depressions,* New York, W. W. Norton & Company, Inc., 1935, pp. 235, 236

The Miller-Tydings Act.—The Sherman Act of 1890 was amended by the Miller-Tydings Act, so as to legalize contracts for the maintenance of resale prices of branded articles wherever such contracts are approved by state laws, as they are in most of the states. Price-cutting on branded articles, and especially their use as "loss-leaders" by chain and department stores, had long been a source of annoyance, both to manufacturers of the goods, who tried by extensive advertising to build up good will for their goods at regular retail prices, and to competing independent merchants who naturally found their own trade injured by such price-cutting. Under the Miller-Tydings Act, the prices of branded goods may be controlled by the manufacturer all the way down the line until they finally reach the ultimate consumer.

The effect of the Act will be to eliminate price competition among the various sellers of a branded commodity. While the Act states specifically that it does not intend to legalize price-fixing as between the various manufacturers of competing brands or articles, it may develop that the power to fix resale prices of their own goods will increase, rather than diminish, the tendency of "monopolistic competitors" to cooperate with respect to price policy. Hence, the ultimate effect of the Act may be to promote the development of trust conditions in industry.

Present Enforcement of Anti-trust Laws.—Since the N.R.A. was declared unconstitutional by the Supreme Court, the anti-trust laws have been in effect once more, but their enforcement has not been highly successful. In 1935, the government lost a suit in which it sought to prevent the merger of the Republic Steel Company and the Corrigan-McKinney Steel Company; but it received a favorable decision from the Supreme Court in 1936 in its case against the American Sugar Institute, a trade association of fifteen refiners who controlled the manufacture of about 75 per cent of the sugar consumed in this country. In January, 1938, at Madison, Wisconsin, some sixteen oil companies and thirty of their officials were convicted, in federal court, of conspiring to raise gasoline prices in the Mid-West; and in the same court, in June, 1938, thirteen major oil companies and eleven of their officials were fined a total of $360,000 after the court accepted their plea of *nolo contendere*, in connection with a charge of conspiring to reduce the margins of jobbers in ten states in the Mid-West.

Other oil companies have recently been under attack in the

Detroit area. In May, 1938, a federal grand jury in South Bend, Indiana, indicted the General Motors Corporation, the Ford Motor Company, and the Chrysler Corporation, on charges of conspiring to violate the Sherman Act by coercing dealers to finance car sales through the finance companies operated by these automobile concerns. In November, 1938, it was announced that the cases against the Ford and Chrysler concerns had been settled by "consent decrees," with the companies agreeing to abandon coercive practices. However, the Department of Justice stated that it would prosecute General Motors vigorously. Other recent suits brought by the government under the anti-trust laws involve the Columbia Gas and Electric Corporation and the American Medical Association. The Federal Trade Commission is continuing its work in connection with the investigation and elimination of unfair trade practices, as is evidenced by numerous "cease and desist" orders issued by the Commission against business firms in recent years. In general, however, the government has been somewhat reluctant to prosecute business men under the anti-trust laws for practices which a few years ago were condoned, if not indeed encouraged, under the N.R.A. codes of fair competition.

A Final Estimate of the Anti-trust Laws.—In spite of whatever accomplishments may be credited to the anti-trust laws of the United States, it must be said that, in general, the government's policy of demolishing trusts and thus enforcing competition in industry, has not been notably effective. The criminal penalties of the Sherman Act have amounted to very little. It has been practically impossible to send men to jail for monopoly activities, and the financial penalties have been too small to be effective. The granting of triple damages to those who have suffered from trust activities has never constituted a serious embarrassment to the trusts. Some trusts the government has not brought into court at all, and some of those accused have been able to escape penalties. It is true that the government has won cases against trusts and the courts have ordered their dissolution, but the dissolutions have rarely, if ever, restored truly competitive conditions in the industries concerned.

The Failure of Trust Dissolutions.—For example, the Standard Oil Company of New Jersey, a holding company which controlled a large part of the petroleum-refining business, was ordered dissolved in 1911. The dissolution, however, consisted of giving the stockholders of the holding company their proportionate

shares of the stock of the underlying companies, so that these companies continued to be controlled by the same people as before. As a result, the successor companies have not competed with one another to any greater extent than while under the control of the holding company.

It may be argued that the dissolution prevented the trust from maintaining or further perfecting its control over the oil business as time went on, and that new companies have arisen to compete with the successor companies even if they have not competed with one another. However, in view of the absence of price competition among the major companies in the industry at present, it must be held that the dissolution was a failure in many respects. Other examples of unsuccessful trust dissolutions might readily be cited.

Clearly, it is exceedingly difficult, if not impossible, either to maintain or to regain competitive conditions in industry by legal enactment. The Federal Trade Commission Act and the Clayton Act were somewhat more successful than the Sherman Act, because they represented a partial change in policy. That is to say, they followed the policy of legislative regulation and administrative supervision of competition, rather than the traditional policy of "trust-busting" and enforced competition. At the present time, our official policy with respect to the trust problem is in a rather unsettled state.

Our Future Trust Policy

The Enforcement of Competition.—There are some people, even today, who believe that the government should continue its policy of "trust-busting" and enforced competition, attempting to make this policy more effective than it has been. Of the many new measures suggested for this purpose, one of the more important was incorporated in a bill which was before Congress at the 1938 session but failed to come to a vote. This Borah-O'Mahoney bill would forbid any corporation with gross assets of $100,000 or more to engage in interstate commerce without a federal license from the Federal Trade Commission. Licenses would be denied to unlawful trusts or combinations, and could be revoked by the federal courts upon proof that a company was engaging in monopolistic practices in violation of the anti-trust laws.

It would seem that the constitutionality of such a measure would

certainly be attacked, and the fate of the law at the hands of the Supreme Court would be a matter of conjecture. If it cleared this hurdle, the law might be somewhat more effective than the laws we now have for dealing with the trust problem. We must recognize the fact that in many industries, in which trust conditions prevail, there is no single dominant firm or combination of firms which can be attacked as a trust. Hence, a measure, such as this one, which would deal with the individual firms and their practices, seems somewhat more realistic in its approach to the problem than laws which aim to destroy "trusts," in the old sense of that term. The measure would doubtless be bitterly attacked by business men, as tending to penalize the stockholders, employees, and creditors of business concerns, by denying them the right to engage in interstate commerce, because of the acts of corporate officials; and as being unenforceable because of the necessity of constant investigation and supervision of some 300,000 firms. Even if the general principle of the measure were accepted, a real fight could be expected in Congress when that body attempted to define specifically the abuses which would constitute grounds for the revocation of federal licenses to engage in interstate commerce.

Other opponents of the trusts would like to see the anti-trust laws rewritten, so as to define undue and unreasonable restraint of trade in terms of the percentage of the total business of an industry which is transacted by a given company. They would expect, by controlling the size of individual companies, to prevent them from growing to trust proportions, or even to a size which would permit price leadership. This proposal would, like the Borah-O'Mahoney measure, attempt to control both trusts, in the old-fashioned sense, and trust conditions which may exist under so-called monopolistic competition.

President Roosevelt, in a recent message to Congress, recommended still further measures for dealing with the trust problem. He proposed to facilitate convictions under the anti-trust laws, by interpreting identical bids on contracts, uniform price increases, price leadership, artificial pricing systems, and other price rigidities as *prima facie* evidence of violation of anti-trust laws. Other proposals include the following: To give the Federal Trade Commission and the Department of Justice increased powers of investigation; to provide more stringent regulations for preventing mergers and consolidations when not clearly in the public interest, and for breaking up interlocking directorates and like devices; to

authorize courts to require the suspension, without pay, of corporate officials responsible for anti-trust law violations; to look into the investments of insurance companies, with particular reference to their use as an instrument of economic power; to prevent the setting up of additional bank holding-companies, and to require the dissolution over a period of time of those which now exist; to change the patent laws to prevent their use in suppressing inventions and fostering monopolies; and to provide further regulation of the activities of trade associations. Acting upon the President's recommendation, Congress set up a committee which proceeded at once to investigate monopoly conditions in American industry.

The Recognition and Control of Trusts.—On the other hand, many students of the trust problem think it might be wise to abandon altogether the policy of attempting to enforce competition in industry, and to substitute a new policy of trust recognition and control. The government might, for example, announce that no further attempts will be made to prevent the growth of trusts by fair methods, or to limit the extent to which one firm or combination may control the affairs of an industry. It would be made clear, however, that the government will continue, through the work of the Federal Trade Commission, to discourage the formation of trusts through the use of unfair methods, and the use of such methods by trusts already established. The trusts would thus be put strictly on their good behavior. If they operated in ways which are not compatible with the public welfare, they would be curbed by the Federal Trade Commission. The Commission, in other words, would be given powers similar to those exercised by the Interstate Commerce Commission in its regulation of the railroads.

This would mean that if the public welfare required it, consolidation could take place only with the Commission's consent, and the Commission would control the issuance of securities by the trusts. It would have jurisdiction over extensions or restrictions of service or output by the trusts. Finally, it would have the power, if necessary, to control the prices charged by the trusts for their products, and the wages paid to and hours of labor required of their workers, in order to prevent the exploitation of either consumers or employees.

But it must not be supposed that there are no objections to a plan of this kind. It is doubtful whether it would be constitu-

tional for the federal government to assume such extensive control over the trusts, under its power to regulate interstate commerce. The control of prices by government or commission is a very difficult thing, and might easily spread to fields which were not considered in the original plan of control. How could the Commission regulate the prices of trust products effectively without regulating also the prices of products which might be substituted for those of the trusts? Could wages and hours be controlled for the trusts without regard to those prevailing in other industries? Would it not be necessary to set the prices paid by the trusts for raw materials also, and thus control the prices of these materials in general? It should be noted that the Interstate Commerce Commission recently found it difficult to control railroad rates and fares effectively without also controlling those charged by buses and trucks.

But there would be many other problems to solve. How would the Commission determine the prices to be charged for trust products? Presumably it would want to set such prices as would permit the trusts to earn a fair rate of return upon a fair valuation of their productive properties. But should a fair valuation be based upon the original cost of the properties, upon their reproduction cost, or upon the capitalization of the trust? If fair valuations are achieved, what is a fair rate of return on them? Should the rate vary from one industry to another? Would not any prices which are set give much larger earnings to some companies than to others? The Interstate Commerce Commission has had great difficulty in handling problems of valuation and rates of earnings. It is often contended in connection with commission control of public utilities that the utilities have come to control the commissions, so that commission control has been largely ineffective. Would this experience be repeated in connection with the trusts?

Despite all these problems and objections, it seems that the policy of recognizing and controlling the trusts may be the best method of handling the situation. If trusts cannot be eliminated, and if their unhampered operation would constitute a grave menace to the public welfare, this policy seems necessary if we are not to resort to the extreme measure of government ownership and operation of the trust industries. Whatever may have been the experience of state commissions in controlling public utilities, certainly the railroads have not come into control of the Interstate Commerce Commission, nor have business firms managed to gain control over the Federal Trade Commission. It seems likely that,

with experience, the Federal Trade Commission could exercise very creditably the additional powers which we have suggested for it.

Government Ownership and Operation.—If recognition and control of the trusts through a government commission should prove unsatisfactory, it might be necessary, as a last resort, to turn to government ownership and operation of the trust industries. Of course, there are those who contend that we should not hold this policy in reserve, but should adopt it at once. They feel that the trusts can never be controlled effectively so long as they remain in private hands, and that government ownership and operation of these industries is essential for the protection of consumers, workers, investors, and producers of the raw materials used by the trusts. They contend that the government could run the industries more efficiently than the trusts, that the industries would be operated with the public welfare instead of maximum private profits as the goal, and that the government could use new devices and methods freely in the industries instead of preventing their use as the trusts do upon occasion. Finally, it is held that the present nefarious activities of the trusts in corrupting government officials and obtaining special tariff favors and other concessions would be eliminated.

However, the opponents of government ownership are equally voluble and sincere. They believe that there is no middle ground between a capitalistic system and a completely socialized state, and that the government ownership and operation of some industries, while others are left in private hands, could lead to only one final result—the control of all economic activity by the state. They suggest that, while the government operation of some industries might be efficient, there is little in past experience with government operation, either here or abroad, to indicate that efficiency is likely to prevail under state control.

The aim of the government in owning and operating these industries might be loftier than that which influences their operation now, but a high aim cannot make up for unsatisfactory results. The critics hold that experience tends to show that the government would be even less progressive than the trusts in the operation of the industries, and that the evils of political control by the trusts at present are nothing in comparison with the evils which would result from subjecting these industries to political control entirely. To these contentions may be added the

suggestion that the government ownership and operation of the trust industries would be a more difficult problem than the oft-proposed nationalization of the railroads, since the trust industries are many and varied in their conditions and problems.

A consideration of the major arguments for and against the government ownership and operation of trust industries emphasizes the difficulty of reaching a valid decision on the subject. We need not conclude, however, that the difficulties involved are necessarily insuperable. If certain industries will apparently be monopolized in any event, it may be the part of wisdom to have the monopoly powers exercised by the government with the public welfare at heart rather than by private business men motivated by their own interests. Certainly it is absurd to argue, as has sometimes been done in the past, that the interests of private business men and those of society are always identical For the present, however, the obstacles to government ownership and operation are sufficiently numerous and serious to lead us to favor a thorough trial of trust recognition and control, as previously outlined, before definitely committing ourselves to the more extreme plan of government ownership.

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1. Distinguish carefully between trusts and business combinations. What is the significance of this distinction? Explain.
2. Explain the principal characteristics of the pool and the trustee device as types of trust organization.
3. Distinguish between the more modern types of organizations exercising trust powers.
4. What is the relationship between "monopolistic competition" and trust conditions in industry?
5. Why is cement production considered a trust industry and cotton textile production a non-trust industry, when neither industry is controlled by a single dominant firm or combination of firms?
6. Have the trusts that have succeeded, done so because they have been able to achieve greater efficiency in production than other business units? Explain fully.
7. What have been the usual effects of trust control on the prices of the products sold by the trust industries?
8. How have the trusts employed unfair competitive tactics in acquiring and maintaining control over certain industries? Explain.
9. On what grounds may the trusts be charged with contributing to business instability?
10. What has been the influence of the trusts in the political field?

11. What are the so-called natural checks on the powers of the trusts?
12. How did the Sherman Act of 1890 attempt to deal with the trust problem, and with what success? Explain.
13. Explain the meaning of the "rule of reason" and its importance in connection with the enforcement of the Sherman Act
14. What were the principal provisions of the Clayton Act of 1914? How was this Act related to the Sherman Act?
15. Describe the chief powers given to the Federal Trade Commission by legislation passed in 1914. Has the Commission been able to exercise these powers effectively? Explain.
16. What was the status of the anti-trust laws under the N.R.A.?
17. What was the effect of the N.R.A. on the trust problem in the United States? Why?
18. Do you feel that the government's program for controlling the trusts has, on the whole, been successful up to the present time? Explain why or why not.
19. Should the federal government continue in the future its traditional policy of "trust-busting" and enforced competition? Explain.
20. What is meant by the policy of trust recognition and control? What criticisms may be directed at this policy?
21. Summarize the arguments for and against government ownership and operation as a solution of the trust problem.
22. What conclusion do you reach as to the desirability of government ownership, in view of your study of the arguments for and against?

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19 AGRICULTURE

THE WIDE PUBLICITY GIVEN TO THE AGRICULTURAL PROBLEM HAS MADE MOST AMERICANS AWARE OF ITS EXISTENCE, BUT THERE ARE many who do not take this problem seriously. They regard our farmers as no worse off than many other enterprisers, but a good deal noisier about such troubles as they have. We believe that this attitude results from a lack of understanding of the situation. It is difficult to believe that anyone who is thoroughly familiar with the importance of American agriculture and the nature of its difficulties could fail to see the seriousness of the agricultural problem that faces us today.

The Importance of American Agriculture.—Agriculture, in addition to being our principal source of food, is important also as a source of supply of raw materials used in manufacturing industries. According to the census of 1930, the farm population was 30,445,350, or 24.8 per cent of the total population of the United States. Estimates for 1935 give a farm population of 31,801,000, or 25 per cent of our estimated total population for that year. In 1930, out of a total acreage of 1,903,217,000, some 986,771,000 acres, or 51.8 per cent, were in farms. There were in the United States, in that year, 6,288,648 farms, and the total value of all farm property was $57,245,544,000, an average of $9103 per farm.[1] The gainfully employed in agriculture in 1930 numbered 10,471,998 persons, or 21.4 per cent of the total for the country. The number of gainfully employed in agriculture was greater than in any other branch of economic activity except manufacturing, in which the total was 14,110,652, or about 35 per cent greater than in agriculture.[2]

Clearly, an industry as extensive as agriculture is of great importance to other industries and to the country as a whole, and not merely to those who devote their energies to it. It is difficult for manufacturing industries or other economic activities to pros-

[1] *Statistical Abstract of the United States, 1935,* p. 557.

[2] *Ibid.,* p. 55.

ɔer when the farmers' income is greatly reduced, or for the ıation as a whole to achieve a high level of economic welfare with \merican agriculture on the verge of economic ruin. And this vas the condition that prevailed in our farming industry in the ;reat depression following 1929.

THE CAUSES OF THE FARM PROBLEM

The Question of Overproduction.—The farm problem was ıot wholly, as some people seem to think, a product of the post-:929 depression. It had existed in more or less serious form at east since the end of the World War in 1918, and was merely ntensified by the depression. If a large number of individuals ;elected at random were asked to name in a word the cause of the :arm problem, it is probable that the majority would blame *ɔverproduction.* Let us see what this term means, as applied to :he agricultural problem. It is practically certain that this country ıas not in recent years had an overproduction of farm products, n the sense of more farm goods than our people would have villingly used if they could have obtained them without payment. \nd it seems equally likely that our total farm output of recent rears could have found purchasers at some price or other.

Whatever overproduction has occurred has been overproduction n the sense that the quantities of farm goods that have been urned out have not been salable at prices which would cover the :osts of production, in the economic sense. As a consequence, arge surpluses of some kinds of farm products accumulated, and n the matter of real income the farmers steadily lost out, as com-ɔared with other types of American producers. Many factors :ontributed to bring about this unfortunate and inequitable ;ituation.

The War Demand for Farm Products.—The tremendous for-:ign demand for American farm products, during and immediately ıfter the World War, gave a great stimulus to agricultural pro-luction in this country. The countries at war had to take many nen, and in some cases much land, out of agricultural production, vith the result that the output of farm products, especially in Europe, fell off greatly. The countries affected were anxious to ɔuy at high and even exorbitant prices all the farm products that ve of the United States would send them. Hence, the war period vas one of rapid increase in the foreign demand for our agricul-:ural produce.

Supply Changes.—On the supply side, important changes took place at about the same time. In the first place, the mechanization of agriculture developed rapidly. The tractor came into more general use on the farm during this period, and made possible the development and utilization of larger, more complicated, and more efficient farming implements of other types than had previously been used. Again, methods of cultivation were improved under the guidance of the United States Department of Agriculture. Our farmers learned much about the control of insect pests and other crop parasites, the benefits of seed selection and proper fertilization, and the most improved methods of animal breeding and feeding. Finally, as a result of the favorable price situation, the improved methods of cultivation, and the mechanization of the farms, still other changes in agriculture took place. It now became feasible to bring under cultivation land areas which had been too poor to use under former conditions. Farmers were encouraged to specialize in raising money crops for the market, instead of continuing to engage in diversified farming. The increasing use of mechanical power, both on and off the farm, reduced the amount of land needed to produce feed crops for animals, and the land released in this way was often devoted to producing more of the great staple money crops. Under the influence of these demand and supply conditions, farm production in the United States increased by leaps and bounds.

Changes in Agricultural Production.—If the years 1910 to 1914 are used as a base period, with an index number of 100, the index number of total crop production in the United States rose from 97 in 1916 to 116 in 1920. Wheat production, which amounted to 635 million bushels in 1916, increased to 952 million bushels in 1919. Cotton production, which was about 11.5 million bales in 1916, increased to about 13.5 million bales in 1920. Corn production rose from 2425 million bushels in 1916 to 3071 million bushels in 1920. Tobacco production, which averaged 1049 million pounds annually from 1911 to 1915, averaged 1386 million pounds annually from 1916 to 1920. Finally, pork production, which averaged 5715 million pounds annually from 1911 to 1915, averaged 6544 million pounds annually from 1916 to 1920.[3]

Changes in Acreage.—In view of these considerable changes in output, increases in the acreage devoted to these products were not very striking. To be sure, the area given to wheat production

[3] *Ibid.*, pp. 617-622.

increased from the annual 1911-15 average of 53 million acres to 74 million acres in 1919, while that used for tobacco increased from the annual 1911-15 average of 1286 thousand acres to 1959 thousand acres in 1919. On the other hand, the corn crop, which used an average of 100 million acres from 1911 to 1915, averaged only 102 million acres from 1916 to 1920, while cotton had an annual average of 34 million acres both from 1911 to 1915 and from 1916 to 1920.[3]

Changes in Agricultural Exports.—Our exports of wheat, which averaged 129 million bushels annually from 1914 to 1916, averaged 156 million bushels from 1917 to 1919, and reached a peak of 293 million bushels in 1921. Cotton exports amounted to 5.3 million bales in 1916, but increased to 6.5 million bales by 1919. Tobacco exports were 348 million pounds in 1915, and 648 million pounds in 1920. Exports of corn, which are never very great, were 179 million bushels in 1921, as against 40 million bushels in 1915.[4]

Changes in Farm Incomes.—The gross farm income of the United States was $7,028,000,000 in 1914, $7,395,000,000 in 1915, $15,101,000,000 in 1918, and $16,935,000,000 in 1919. Even these large increases in income would not have meant much to the farmers if the prices of products they bought had increased as fast as the prices they received for their own products, but this was not the case. If the years 1909 to 1914 are taken as the base period for index numbers of both prices received by and prices paid by farmers, we find that prices received by farmers were 202 in 1918, while prices paid by farmers were 176. In 1919, these two index numbers were 213 and 202, respectively.[5] Therefore, the farm income of this country increased both absolutely and in relative purchasing power during the war and early post-war years.

Post-war Demand and Supply Conditions.—But these favorable conditions for American agriculture did not last long. After the close of the World War, agricultural production picked up in Europe so that within a few years many of the European countries had reached the pre-war level in this respect. As a result, their demand for American farm products declined. Moreover, many of the less highly industrialized parts of the world were able to increase their agricultural production substantially through the

[4] *Ibid*, pp. 458-461.
[5] *Ibid.*, pp. 680, 681.

use of improved methods and machinery; and they began to compete strenuously for the foreign markets which Americans had been supplying with farm products. Some European countries were not content to have their agricultural production merely reach pre-war levels. Under the influence of programs of extreme nationalism, many attempted to become self-sufficient, or largely so, with respect to important foods and raw materials, which they had formerly imported in large quantities. This they did despite the fact that their land areas were often poorly adapted to raising these goods, so that the costs of producing them at home were excessive.

The American policy of discouraging imports, as developed in our high protective tariff laws after the war, hindered our farmers in their efforts to retain export markets. The eventual and inevitable curtailment of the large loans Americans had been granting abroad for the purpose of financing exports increased the difficulty of selling farm products to foreigners. From the domestic point of view it may be true, as is often claimed, that changes in the diet of the American people had a depressing influence on the market for farm products, and the adoption of prohibition may have had a similar effect.

At any rate, the total demand for American farm products fell off within a few years after the close of the World War. In the face of this decline, methods of farming apparently continued to improve and the trend in agricultural output was upward (or, at least, stable) until well after the beginning of the depression in 1929. Corn acreage, which averaged 102 millions from 1916 to 1920, amounted to 101 millions in 1930, 106 millions in 1931, and 109 millions in 1932 at the depth of the depression. Wheat acreage, which had only once been above 65 millions, was 63 millions in 1930 and 57 millions in 1931 and 1932. Cotton acreage, which amounted to 33 millions in 1919, increased to 45 millions in 1926, and was 39 millions in 1931 and 36 millions in 1932. Tobacco production, which used 1959 thousand acres in 1919, used 2112 thousand in 1930, 2000 thousand in 1931, and 1409 thousand in 1932.[6]

Agricultural Production and Exports.—The index number of total crop production in the United States which had been 116 at the peak of demand in 1920, on the basis of 1909-14 as 100, was still 110 in 1931 and 108 in 1932. Production of some indi-

[6] *Ibid.*, pp. 617-622.

vidual staple crops was still worse, from the point of view of excessive output. Corn production, which had exceeded 3000 million bushels only once since 1914, was still 2589 million bushels in 1931 and 2907 million bushels in 1932. Wheat production, which had totaled 952 million bushels in 1919, was 932 million bushels in 1931 and 746 million bushels in 1932. Cotton production, which reached 13.5 million bales in 1920, had increased to 17.1 million bales in 1931 and was still 13 million bales in 1932. Tobacco production, with 1386 million pounds, on the average, from 1916 to 1920, was 1647 million pounds in 1930 and 1584 million pounds in 1931. Finally, pork production, which averaged 6544 million pounds annually from 1916 to 1920, was 7831 million pounds in 1931 and 1932.[6]

At the same time, exports of farm products declined sharply from war and early post-war levels. Cotton exports made the most favorable showing, since they declined from a peak of 10.9 million bales in 1926 merely to 8.7 and 8.4 million bales in 1931 and 1932, respectively. Tobacco exports, which totaled 648 million pounds in 1920, declined to 591 and 432 million pounds in 1931 and 1932, respectively. Corn exports, which had amounted to 179 million bushels in 1921, declined to 3 million bushels in 1930, 4 million in 1931, and 9 million in 1932. Wheat exports, which had reached a peak of 293 million bushels in 1921, declined to 92 million bushels in 1930, 76 million in 1931, and 97 million in 1932.[7]

Farm Income.—With the output of important staple crops changing only slightly despite the loss of export markets and depression conditions at home, the farm income of the United States fell seriously in the years following 1929. The total farm value of the corn crop, which was $4,035,000,000 in 1919, was only $831,000,000 in 1931 and $925,000,000 in 1932. The value of the wheat crop declined from $2,059,000,000 in 1919 to $364,-000,000 in 1931 and $283,000,000 in 1932. The value of the tobacco crop fell from $288,000,000 in 1923 to $130,000,000 in 1931 and $108,000,000 in 1932. The value of the cotton crop, which was $2,020,000,000 in 1919, was only $483,000,000 in 1931 and $424,000,000 in 1932.[8] The tremendous declines in value indicate the inelastic nature of the demand for these products. An illustration is afforded by the cotton crop, which brought in

[7] *Ibid.*, pp. 458-461.
[8] *Ibid.*, pp. 617-622.

$2,020,000,000 in 1919 from the sale of 11,411,000 bales, while it yielded only $483,000,000 in 1931 for 17,096,000 bales. To be sure, these results occurred under different conditions of demand and of general business, but the suggestion of inelastic demand remains strong.

The total gross farm income of the United States, which reached a peak of $16,935,000,000 in 1919 and was still $11,941,000,000 in 1929, fell to $6,968,000,000 in 1931 and to $5,337,000,000 in 1932. The total cash income available to farmers, after paying wages to hired labor, interest, taxes, and various operating expenses, was $4,890,000,000 in 1929, but declined to $2,091,000,000 in 1931 and to $1,473,000,000 in 1932.[9] The effects of the decline in farm income were the more severe because the prices received by farmers for their products fell faster and further than the prices paid by farmers for the goods they bought. Many of our manufacturing industries, by virtue of their monopolistic or semi-monopolistic situations, were able to keep prices relatively stable during the depression and take their losses in the form of idle plant and equipment rather than by selling their products at low prices. If, in the face of a declining national income, some prices refuse to fall, the effect is to depress other, competitive prices to a greater extent than would otherwise be necessary. The farm industry, being operated by millions of independent enterprisers, was unable to protect itself in this situation, and the fall in farm prices was disastrous.

Farm and Other Prices.—If the years from 1909 to 1914 are taken as a base period for both index numbers, the index number of prices received by farmers has never been as high since 1920 as the index number of prices paid by farmers. In the prosperous days of 1929, prices paid by farmers stood at 153, while those received by farmers were at 146. In 1931, prices received by farmers were at 87, while those paid by farmers were at 124, and in 1932 the two index numbers were 65 and 107, respectively.[10] The *ratio* between these index numbers in 1932 was 61. This means that in that year the farmer, by giving up products worth $1.00 in terms of the base period, could obtain other products worth 61 cents in terms of the same period.

Expressed in slightly different terms, it may be said that, from 1929 to the spring of 1933, the output of farm products declined

[9] *Ibid.*, p. 590.
[10] *Ibid.*, pp. 680, 681.

only 6 per cent, while the prices of these products dropped 63 per cent. In the same period, the output of farm implements dropped 80 per cent, of motor vehicles 80 per cent, of cement 65 per cent, of iron and steel 83 per cent, and of automobile tires 70 per cent. However, the prices of farm implements in this period declined only 6 per cent, of automobiles 16 per cent, of cement 18 per cent, of iron and steel 20 per cent, and of automobile tires 33 per cent.[11] Hence, the purchasing power of the farmer was greatly reduced during the depression.

The Insensitiveness of Farming.—Two important questions should be raised at this point. The first of these is, Why did not the farm industry, like the manufacturing industries, recognize the existence of unfavorable demand conditions and reduce output all along the line? And the second question is, Would not the farm problem have solved itself eventually through the operation of natural economic forces, such as the business failure of increasing numbers of farmers and the gradual reduction of the acreage in cultivation and, hence, in the size of crops?

In answer to these questions, it may be said that farming is apparently less sensitive than most industries to changes in demand conditions and the prices of its products. When manufacturers can no longer make ends meet, they fail and their output is withdrawn from the market. Or, in some instances, manufacturing concerns, before reaching the failure stage, decide to cooperate with one another in the reduction of output and maintenance of prices. The farmer seldom fails. Those who have lent him money are usually lenient in allowing him to continue in business, even though he defaults on his obligations. Even when he loses his farm through mortgage foreclosure, he is often permitted to remain on the land and cultivate it. Moreover, it is practically impossible for the many independent growers of a crop to cooperate with one another voluntarily to restrict output and maintain prices as manufacturers are given to doing.

So long as the farmer can stay on the land, he is likely to keep on producing to the utmost of his ability. Interest and taxes bulk large among his money expenses. These are in the nature of fixed costs and cannot be reduced easily, if at all. When the prices of his products fall, he can save comparatively little by cutting down output. Therefore, falling prices for farm products may lead to

[11] United States Department of Agriculture, *Yearbook of Agriculture, 1935*, Washington, Government Printing Office, 1935, p. 5.

increased, rather than decreased, farm production, since it takes more bushels of wheat or pounds of cotton to pay a given amount in taxes or interest when farm prices are low than when they are high.

The Farmer's Fixed Costs.—The burden of fixed costs has borne heavily on the farmer since the World War. Agriculture was so prosperous during and immediately following the war, that farming land increased rapidly in value, and many farms changed hands at greatly inflated prices. The mortgages which usually accompanied such changes in ownership called for large interest payments and these became difficult to meet in later years. The total amount of interest payable by farmers in 1930, 1931, and 1932 was 96, 92, and 87 per cent, respectively, of the total payable by them in 1929. Similarly, the assessments on farming land for tax purposes increased during and after the World War, and it was difficult, of course, to secure later reductions in these assessments. The taxes payable by American farmers in 1930, 1931, and 1932 were 100, 92, and 79 per cent, respectively, of their 1929 taxes.[12]

Thus, in the great depression following 1929, the farmers, with their fairly stable money costs and sharply reduced incomes, were in very serious straits. Thousands lost their farms through foreclosure and the situation finally became so bad that groups of farmers sometimes banded together to prevent foreclosures and sheriff's sales, even by violence if necessary. There were also farmers' strikes and riots, in which groups of farmers attempted to destroy farm produce on its way to the market, or otherwise to prevent the marketing of farm products until prices should improve. In some cases, crops were left to rot in the fields, or were destroyed, because they could not be sold at prices sufficiently high to cover even the necessary expenses of harvesting them. It may be argued, several years after the event, that these conditions in agriculture would eventually have corrected themselves through the action of natural economic forces. A solution of the farm problem might or might not have come about in this way. Given the best of good luck, solving the farmers' difficulties without governmental assistance would have been a long and painful process. At any rate, attempts had previously been made to give assistance to the farmers and, since the Roosevelt administration

[12] *Statistical Abstract of the United States, 1935,* p. 590.

undertook to adopt a general recovery program, it was probably necessary both economically and politically to do something about the agricultural problem.

Soil Erosion.—The farm problem, as we have already described it, was bad enough but in recent years our farmers have been menaced by a serious increase in soil erosion. While soil erosion is not of recent origin, it has only lately come to command great public attention. The extension of cultivation to new areas formerly used for grazing has stripped the soil of natural protective vegetation and, as a result, the uncontrolled forces of wind and water have severely damaged millions of acres of farming land.

In some parts of the country, the land, denuded of trees and other vegetation, is no longer able to hold the moisture which it receives at times. A considerable part of the rainfall runs off the surface, provides but little moisture for plant growth, and carries away with it many tons of fertile soil. But in the past several years soil erosion by wind has perhaps exceeded erosion by water in its destructive effects. Some of the severe dust storms originating in our western states have moved eastward to the Atlantic coast and passed out to sea, bearing with them untold thousands of tons of valuable soil whirling about in the air at a height of two to three miles.

According to government reports, soil erosion has ruined some 50,000,000 acres of farm land and badly damaged 50,000,000 acres more, while much additional land is in serious danger. Erosion dissipates fertile soil through dust storms, piles up soil on the lower slopes, spreads poor subsoil over rich bottom lands, increases the danger of floods, and robs wild animal life of essential food and cover. It also leads to the silting and sedimentation of stream channels, reservoirs, dams, ditches, and harbors, and damages roads, railways, irrigation works, power plants, and public water supplies.[13]

Soil erosion is said to be largely the result of overcropping—an unsound practice which, besides leading to erosion, makes the tillage of the soil more difficult, reduces its content of plant food, and increases the danger of drought. Depletion of the soil has been especially serious in the South, where an average of 80 per cent of the agricultural land has been kept in soil-depleting crops. Such crops as cotton and corn leave the land bare in the winter

[13] *Yearbook of Agriculture, 1937*, p. 19 *et seq.*

season and highly subject to erosion under the influence of the moderate climate and heavy rainfall.[14]

Methods have been devised for controlling soil erosion, but it is difficult to accomplish much through individual action, since the average farmer lacks the necessary skill, the financial means, and even the incentive to attempt erosion control. Since erosion is caused, or at least facilitated, by unwise use of the soil, it is directly related to the agricultural problem as a whole. It is possible to prevent or greatly reduce soil erosion by putting land into such close-growing crops as alfalfa or bluegrass, but it is difficult for farmers to do this when their economic situation is so acute that they need all their land for money crops, such as wheat or cotton. Even the rotation of soil-protecting crops with money crops in alternate years would be helpful in checking soil erosion; but when farmers need, year after year, every penny that they can scrape together, they are likely to plant money crops continuously and let nature take its vengeance. In any case, the individual farmer usually feels that he can do little about soil erosion without the cooperation of other farmers. The methods of handling soil erosion, and the present program of the federal government, will be described in the next chapter.

Early Attempts to Solve the Farm Problem

We have seen that the farm problem was not caused by the post-1929 depression, but was merely intensified by it. Furthermore, attempts to solve the problem did not wait upon the great depression, but began to appear soon after the World War. The first important attempt of this kind took the form of tariff changes in 1922, which placed high rates of duty on imports of agricultural products. The avowed purpose was to protect the domestic market of the American farmer. But he already had such protection, for imports of agricultural products competing with our own had never been heavy. The protection of the home market did our farmers little good, for they were producing agricultural goods in quantities too great to be absorbed by the domestic market at favorable prices, and were rapidly losing their essential export markets. What the farmers really needed was the ability to export. The only tariff change capable of helping the farmer would have been a reduction in the tariff duties on imported manufactures,

[14] *Ibid.*, p. 13.

enabling foreigners to sell their goods to us and thus be in a position to buy our surplus farm produce.

Attempts to Control Surplus Production.—Since the farmers were producing more than the domestic market could absorb, and were losing their export markets, attention turned in the next few years to the question of surplus production. Two measures designed to give relief were vetoed by President Coolidge. One of these, the McNary-Haugen Act, provided that a so-called equalization fee or tax should be levied on the output of certain agricultural products, to provide funds to reimburse farmers for the losses incurred in exporting surplus farm products. This plan was expected to decrease the volume of agricultural products sold in the domestic market and maintain domestic prices for these articles well above the foreign level. The second relief measure involved what was called the debenture plan. The idea was to stimulate the exportation of farm products by granting bounties, in the form of debenture certificates, for such exports. The bounties were to equal the difference between the domestic prices of farm products and the prices received in the foreign market. The certificates were to be accepted by the federal government in payment of import duties, so that there would be a ready market for them. The purpose of this Act was, of course, to reduce the volume of farm products sold in the domestic market and thus raise prices.

The Federal Farm Board.—In 1929, the Agricultural Marketing Act was passed by Congress and approved by President Hoover. The Federal Farm Board was set up to carry out the provisions of the Act, and was given one-half billion dollars for use in stabilizing the prices of farm products. While more than one course of action was open to the Board, its chief activity consisted of the purchase of a large part of our surplus output of such products as wheat and cotton, and the storage of these commodities in warehouses. For a time, the Board had some success in producing artificially high prices for these articles, but it failed eventually because it attempted to provide high prices for farm products without putting any effective check upon agricultural production. Naturally, the financially embarrassed farmers, with no restrictions on production, were stimulated by the high prices to increase their output. It seems likely that the equalization fee and debenture plans would, like the Agricultural Marketing Act, have proved defective as solutions of the farm problem.

The Farm Credit Policies of the Roosevelt Administration

In the presidential campaign of 1932, the Democratic party promised real relief to American farmers; and it must be said that the Roosevelt administration has been untiring in its efforts to find a way out for the farmers, however ill advised certain of its policies may seem to some people. The discussion of the policies of the administration will be divided between the present and the following chapters.

The Farm Credit Administration.—Several steps were taken by the Roosevelt administration, in its first year in power, to provide debt relief and additional credit facilities for farmers. The Farm Credit Administration was formed in 1933 by executive order for the purpose of bringing a number of existing farm credit agencies under one head, and administering the emergency legislation. Operating under the Farm Credit Act, it helped farmers to develop a system of several hundred local production credit associations, to provide farmers with production and marketing credit at low cost. These associations make loans to farmers on crop and chattel security and charge interest rates of approximately 5 per cent, which is some 2 or 3 per cent less than private agencies would charge for the same type of credit.

Emergency Farm Mortgage Legislation.—As has been suggested, the farm mortgage situation during the depression was desperate. In 1932, farm mortgage debts amounted to 8.5 billion dollars, out of a total farm debt of 12 billion dollars. The total debt was more than twice the amount of the gross farm income of 1932, and about equal to that of 1929. Under the Emergency Farm Mortgage Act, the Farm Credit Administration reorganized the Federal Land Bank System and set about refinancing farm mortgage debts. The Act authorized for this purpose the issue of two billion dollars' worth of new Federal Farm Loan Bonds, on which the federal government guaranteed interest at the rate of 4 per cent. The proceeds of the bond issue were used to make new loans to farmers or to purchase their mortgages, while some bonds were exchanged directly for mortgages.

The holders of farm mortgages, anxious for settlement after a long period of waiting, were sometimes willing to scale down their claims. Such reductions were obligatory in some cases, for the Land Bank loans, with prior liens, could not exceed 75 per

cent of the normal value of the property given as security. In any event, after the mortgages were taken over by the government, the process of refinancing began. These new mortgage obligations of the farmers were to be liquidated over a long period of years, and no payments on the principal had to be made for five years. The interest charge was not to exceed 4½ per cent, as compared with 5 to 6½ per cent formerly paid by farmers. By 1936, agencies of the Farm Credit Administration were holding farm mortgage loans to the amount of $2,869,000,000.[15]

Mortgage Moratoriums.—The original Frazier-Lemke Act provided a five-year moratorium on a farmer's obligation, if it proved impossible to reduce his debt to a sum which would permit him to pay off his mortgage. That is, under the law, a farmer's property could not be taken through foreclosure within a five-year period, provided the farmer paid a reasonable rental to the creditor during this time. After five years, the farmer could obtain a clear title to his mortgaged property by paying its appraised value, regardless of the amount of the obligation specified in the original mortgage. However, this Act was declared unconstitutional in May, 1935, by unanimous vote of the Supreme Court. It was said to violate the Fifth Amendment to the Constitution, by taking from the mortgage holder some of his specific rights in the property which secured the mortgage, without just compensation.

Undaunted by this experience, Congress passed a new Frazier-Lemke Act later in 1935. Under this Act, a farmer, faced with foreclosure and unable to get a reduction in his mortgage obligations by direct dealings with his creditors, could apply to the courts to declare him a bankrupt. The court dealing with his case was given the power to stay all legal proceedings against the farmer for a period of three years, during which time he could retain possession and use of the mortgaged property by paying a reasonable rental. At any time during the three years, the court could order an appraisal of the mortgaged property and the farmer could obtain full title to it by paying the appraised value, regardless of the amount of the mortgage obligation.

To protect the rights of creditors, which were damaged by the original Act, the new law provided that any creditor who had as security a lien on the property could demand that it be sold at public auction. In this case, the court was required to conduct

[15] *Ibid.*, p. 58.

such a sale after due notice, but the former owner was thereafter to be given ninety days within which he could recover full title to his property by paying the auction price, plus interest at 5 per cent. In the spring of 1937, this Act too was passed upon by the Supreme Court, and was declared constitutional. The Court realized that the new law sought to attain its ends in a somewhat different way, and decided that it avoided many of the defects of the original Act. Yet another Frazier-Lemke Bill was introduced in Congress at the 1936 session, but failed to pass.

The Desirability of Debt Relief.—We have emphasized the fact that the farmer's difficulties arose from the necessity of paying a fixed amount of principal and interest while his income declined sharply because of the depression. If the government was to help out, here was at least one desirable point of attack. Of course, it may be argued that there was no reason to give the farmers preferential treatment in this respect; but it should be remembered that home owners other than farmers were given similar relief through the Home Owners' Loan Corporation, and many types of business men were given financial assistance through the Reconstruction Finance Corporation. There has been some question as to the safety of the funds invested by the government in refinancing farmers' mortgages. If agricultural conditions are no better in the future than in the past, this money may not be recoverable, and may have to be written off as a subsidy to agriculture. The debt program is, of course, related indirectly to the main agricultural adjustment program. With the pressure of debt obligations reduced, the farmers no longer feel it imperative to keep every possible acre of soil planted to money crops, and are willing to cooperate in a program for controlling agricultural production. By many people, the debt relief program is credited with preventing the complete financial breakdown of the farm industry.

The Commodity Credit Corporation.—In late 1933, the Commodity Credit Corporation was set up for the purpose of making loans to farmers on their holdings of specified crops. It could lend a farmer 10 cents a pound on his cotton, without liability to him, if he would agree to take part in the 1934 acreage reduction program. A similar offer was made available for corn growers, after the corn-hog adjustment program had been set up. That is, in states where corn could be held on the farm under seal, secured by warehouse receipts, the growers could secure a

loan of 50 cents a bushel on their holdings, provided they agreed to cooperate in the agricultural adjustment program in the following year. These provisions for loans assured the growers a certain return for their products, and still enabled them to gain by any increases in prices which might result from the operation of the agricultural adjustment program.

Thus, we see that the work of the Commodity Credit Corporation was closely tied up with that of the Agricultural Adjustment Administration. If loans had not been made available to the farmers, they probably would have had to throw their crops on the market for whatever they would bring, thus depressing the prices of these products still further, or at least keeping the prices from rising. The loans made it possible for farmers to withhold a part of their current production from the market, and thus aided the Administration in realizing its object of raising the prices of these agricultural products. In several recent years, some of the farm credit agencies received in repayments larger sums than they paid out in new loans, but this trend was reversed during the business recession of 1938, under the influence of the new agricultural program of that year.

Aims and Methods of the Agricultural Adjustment Program

The principal aim of the Roosevelt administration in aiding American farmers was to increase farm incomes and purchasing power by controlling production and raising prices. This aim was to be accomplished through the administration of the Agricultural Adjustment Act of 1933. The preamble to this law declared that the great depression was caused in part by the severe and increasing disparity between the prices of agricultural products and other commodities; for this disparity had largely destroyed the power of the farmers to purchase manufactured products, had interfered with the orderly exchange of commodities, and had seriously impaired the agricultural assets supporting the national credit structure. Thus it was held necessary, for recovery purposes, to enact legislation for the benefit of the farmers.

The Purpose of the Agricultural Adjustment Act.—The Act declared that it was the policy of Congress to establish and maintain a relationship between the production and consumption of farm products which would bring the prices received by farmers to such a level as to give these farm products a purchasing

power, in terms of the commodities that farmers buy, equivalent to the purchasing power of the farm products in the "base period." This period was the five years preceding the World War, or from the middle of 1909 to the middle of 1914, except in the case of tobacco. The policy was to be put into effect as rapidly as possible. The interests of consumers were to be protected by seeing to it that the adjustment of farm production did not raise the percentage of the consumers' total retail expenditures which farmers received above the percentage which they received during the base period.

The Reduction of Output.—To achieve the objects of this legislation, the Secretary of Agriculture was empowered to arrange for reductions in the output of basic agricultural commodities, by making agreements with farmers to cut down acreage and paying them rentals or benefits in return for such cooperation. The amount of reduction required in the case of specific farm products, and the amount of benefit or rental payments, were to be determined by the Secretary of Agriculture.

The Processing Taxes.—To secure funds with which to administer the Act and pay benefits to farmers, the Secretary was authorized to levy taxes upon the first processors of these basic farm products. The processing tax on each product was to equal the difference between its current average farm price and its "fair exchange value"—that is, a price which would give the seller as much purchasing power as its sale would have given during the base period 1909-14. However, if it developed that this rate of tax would not prevent the accumulation of a surplus stock of commodity, a higher or lower tax rate could be charged.

The Cotton Options.—An alternative form of treatment was provided for cotton growers. The Secretary was empowered to sell, to any cotton grower, options on cotton held by the government up to 30 per cent of the grower's production in the previous year, providing the grower agreed to reduce his current production by the same amount. When the price of cotton advanced because of the reduction in acreage, the grower would be enabled to reap a profit on the options taken at a lower price.

Marketing Agreements and Licenses.—As an alternative form of control, the Secretary was permitted to enter into marketing agreements with processors, associations of producers, and others engaged in handling agricultural commodities or products thereof in interstate commerce, and to require these persons to

obtain licenses authorizing them to carry on their customary activities in connection with these or competing products. These licenses might be suspended or revoked for cause, and the licensees could be required to furnish detailed information as to their business transactions in these products.

The Operation of the Agricultural Adjustment Act

The Basic Commodities.—The commodities specifically mentioned as basic in the original Act were wheat, cotton, field corn, hogs, rice, tobacco, and milk and its products. It should not be inferred, however, that rental payments for acreage reduction were made to farmers and processing taxes applied in the case of each of these products. As a matter of fact, processing taxes were placed on only wheat, cotton, hogs, and tobacco. The tax on hogs was supposed to cover benefit payments to both hog raisers and corn growers, since most corn is fed directly to hogs and comparatively little is processed for human consumption.

Emergency Restrictions of Output.—It was impossible to get the system of benefit payments and processing taxes into effective operation before the crop year 1934, so that emergency programs were adopted for some crops in 1933, notably in the case of hogs and cotton. More than six million sows and little pigs were purchased by the Agricultural Adjustment Administration, to reduce the amount of pork which would be marketed in following months. The edible pork products derived from the slaughter of these animals were given to the Federal Emergency Relief Administration for distribution among the unemployed. In the case of cotton, arrangements were made to remunerate the growers for plowing under some ten million acres of the 1933 crop, since it was too late to restrict the acreage planted. Though it was the policy of the Administration to avoid the destruction of commodities already produced or growing, it was thought that the seriously low prices of hogs and cotton did not make it feasible to delay action until 1934.

The 1934 Reduction Program.—For the year 1934, contracts were signed with the producers of cotton, wheat, tobacco, corn, and hogs, providing for the restriction of production in varying amounts. At the time it was thought desirable to reduce the output of cotton by 40 per cent, of wheat by 15 per cent, of corn by 20 per cent, and of hogs by 25 per cent. We may get an idea of the

operation of the reduction program by noting its operation in the case of cotton.

According to the Secretary of Agriculture, about 1,010,000 contracts were signed with individual cotton growers affecting the 1934 crop. Every grower of cotton who accepted the plan promised to reduce his acreage planted to cotton by not less than 35 per cent or more than 45 per cent of his average acreage during the preceding five years; and these idle acres he leased to the Secretary of Agriculture. The grower also agreed to reduce his cotton acreage in 1935 by not more than 25 per cent on the basis of his five-year average, if the Secretary decided that crop reduction was necessary in that year. He promised, also, not to increase his total acreage of *all* crops, after deducting the contracted reduction in cotton acreage; not to increase his acreage in other "basic commodities"; and to use the land rented by the Secretary only for such purposes as might meet with the approval of that official.

In return for his cooperation in the respects outlined above, the cotton grower was to receive from the government a benefit or rental payment which would amount, on the average, to about 4½ cents per pound on the cotton which would have been grown on the land rented to the Secretary, based upon the five-year average production for 1928 to 1932. Since cotton production during this period averaged about 174 pounds an acre, this meant a payment of $7.85, on the average, per acre of land removed from cultivation. If considered as rent alone, this would have been quite a heavy payment for the land, but it was intended also to compensate cotton growers for labor and capital withheld from production. The necessary revenue to pay these benefits was to be raised through taxes levied on the first processors of cotton. Manufacturers of cotton goods were required to pay taxes based on the quantity of raw cotton entering into their products. Raw cotton sold abroad was not subject to the processing tax, and the producers of manufactured articles containing cotton were given a tax refund on any of their products that were exported.

During the growing season of 1934, it was feared that the cotton reduction program would not be adequate, and Congress passed the Bankhead Act providing for the compulsory reduction of the cotton crop. This Act provided a tax of 50 per cent on the value of all cotton raised by any grower in excess of the amount allotted to him. Individual allotments were to total about 10 million bales, and this was the maximum amount of cotton which could be

marketed free of the 50 per cent tax. Each individual allotment was based upon the grower's average production during the preceding five years. A grower was given tax exemption certificates to the extent of his allotment, and a degree of elasticity was introduced into the program by permitting growers, who did not produce the full amount of their allotments, to dispose of their certificates to growers whose production exceeded their allotments. However, the actual cotton production in 1934 was only 9,636,000 bales.

The 1,010,000 cotton contracts involved the rental to the government of some 14,600,000 acres of cotton land, and required payments to growers amounting to $116,686,000. In similar fashion, contracts were signed by the Secretary of Agriculture and the growers of other basic commodities. Some 289,000 contracts were signed by tobacco growers who controlled a total base acreage of 1,810,000 acres. These contracts called for an average reduction of 34 per cent from base acreage. Over a million wheat contracts were signed by growers controlling 78 per cent of official seeded acreage, and involved benefit payments of about $102,000,000. Some 1,155,000 corn-hog contracts were signed, calling for a reduction of 24 per cent from base corn acreage. Benefits for adjusting corn acreage totaled approximately $112,000,000, while those for adjusting hog production amounted to about $204,000,000.[16]

Actual Reductions in Acreage.—In the case of most of the basic crops in which reduced production was sought, the actual number of acres withheld from use was somewhat smaller than the number the contract signers had agreed to withdraw. Farmers who had not previously raised the basic crops and who consequently did not sign contracts in some instances decided to produce these commodities, and other producers whose acreage in basic crops was so small that they did not think it worth while to sign contracts expanded their production to some extent.

Marketing Agreements.—As we have said, not all of the basic commodities were regulated through the adoption of benefit payments and processing taxes. The production and prices of these other basic commodities were controlled by marketing agreements. In the case of milk, for example, separate agreements were drawn up for the milk sheds which supply various areas of the country.

[16] The figures relating to the 1934 crop reduction program are taken from the *Yearbook of Agriculture, 1935*.

These agreements were usually based on previous state or local agreements, and on practices already in existence in the various milk sheds, and constituted contracts between producers and distributors. The agreements were enforced by issuing licenses to all producers and distributors, whether they signed the original agreement or not. These licenses could be withdrawn for violations.

The first agreements that were drawn up often provided for minimum prices to both producers and distributors, but the fixing of minimum retail prices was later abandoned as a general principle. However, the distributors who purchased their supplies of milk from producers were required to pay fixed minimum prices, these prices depending upon the uses which were to be made of the milk. The highest price was paid for whatever was to be sold as fluid milk, and the lowest for milk to be made into butter. Different prices for milk were set for the various milk sheds. New producers were required to sell their milk at the lowest price for their district for a period of ninety days, and producers in general were expected to control their production according to the quantities they could sell as fluid milk and for other purposes.

Other Policies of the A.A.A.—In addition to the purchase of sows and little pigs, as previously noted, the Agricultural Adjustment Administration bought substantial amounts of butter and cheese for distribution to families on relief, through the Federal Emergency Relief Administration. However, the most comprehensive program of direct purchase was the governmental purchase of cattle, sheep, and goats in the drought area in 1934. Because of the drought, grain, forage, and pasture were exceedingly scarce in certain states, and water as well in some instances. The purchase of livestock by the government prevented the total loss that many farmers would have suffered without this timely aid, and to others brought prices superior to those which could have been had by marketing their stock through regular channels. Moreover, the purchases were directly in line with the Administration's program for reducing the production of farm commodities. The resulting edible products were distributed, as usual, to needy families through the Federal Emergency Relief Administration. We mentioned, in an earlier section, the Farm Credit Administration's policy of lending money to farmers on the basis of their holdings of certain basic crops.

The Increase in the Number of Basic Products.—In 1934, the list of basic products coming under the Agricultural Adjust-

ment Act was amended to include beef and dairy cattle, sugar, peanuts, rye, flax, barley, and grain sorghums. Processing taxes and benefit payments were soon provided for sugar and peanuts. In 1935, Congress passed a very rigid production control bill for potatoes. The law provided that no farmer should raise and sell more than five bushels of potatoes without getting a permit from the Administration, and that allotments of the amount a person might raise would be assigned to each farmer. Any grower who exceeded his quota or failed to obtain a permit was subject to a tax of 45 cents per bushel on his excess production in the first case, and on his entire output in the second case.

All potatoes sold by farmers were to be marketed in closed containers prescribed by the Administration, and these containers were required to bear a government stamp. A farmer who sold potatoes not properly packed, or not bearing a stamp, was subject to a fine of $1000 for the first offense and a year's imprisonment for the second. A buyer of potatoes not packaged and stamped was subject to similar penalties, as were also any persons who refused to furnish on demand any information they possessed about the production and sale of potatoes. Finally, every farmer raising more than five bushels of potatoes was required to keep such records as the Administration might specify. A storm of protest on the part of farmers, consumers, and political writers followed the enactment of this law. The law was never put into effect, probably because of its unpopularity, though ostensibly because of lack of funds for its enforcement; for the appropriation of these funds was included in a bill which failed to pass the Senate in 1935 as the result of the late Senator Huey Long's last filibuster.

The Amendments of 1935.—The Agricultural Adjustment Act was amended in several respects in 1935. One change was intended to strengthen the constitutionality of the Act by replacing the original, vague delegation of powers to the Secretary of Agriculture with a specific statement of these powers. It limited the application of the Act to articles destined to move in interstate commerce, and ratified and confirmed all administrative acts performed under the law prior to the passage of the amendments. The amending Act prohibited injunction suits designed to prevent the collection of processing taxes and prescribed the means by which refunds could be obtained, when justified. The export debenture plan was written into the amending Act in permissive form —that is, it allowed 30 per cent of the receipts from import duties

to be used for subsidizing the exportation of surpluses of farm products other than raw cotton. The licensing of handlers as a means of enforcing marketing agreements was discontinued, and price-fixing was eliminated for all commodities except milk. Finally, the Bankhead Cotton Control Act, and the similar Kerr-Smith Act for tobacco, were extended for another year.

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1. Give statistics which suggest the importance of agriculture in our economic system.
2. How is the welfare of agriculture connected with that of other industries and with the welfare of the nation as a whole?
3. In what sense has there been an overproduction of farm products in recent years? Explain.
4. What stimulus caused American agriculture to expand production during and immediately following the World War?
5. What changes in supply conditions in agriculture were taking place at the same time?
6. Indicate the extent to which agricultural production in the United States increased during and just after the World War.
7. Was this increase in production due to an expansion in farm acreage? Explain.
8. What happened to our exports of farm products during the same period?
9. Discuss the change which took place in the income position of agriculture during this period.
10. What happened to demand conditions for farm products after the World War? How were our exports of farm products affected?
11. Did farm production adjust itself to these changed conditions of demand? Explain.
12. Comment on the fate of farm income and the value of major crops in the depression following 1929.
13. How did the behavior of agricultural output and prices in the depression differ from that of output and prices in certain manufacturing industries?
14. Explain fully what is meant by "the insensitiveness of farming."
15. The burden of fixed costs to the farmer grew heavier during the depression. Explain.
16. Would the farm problem have cured itself eventually through the operation of natural economic forces? Explain.
17. What is the nature of the problem of soil erosion?
18. Show how the problem of soil erosion is related to other phases of the agricultural problem.

19. Could American farmers be assisted by placing high tariff rates on imports of farm products?
20. How were the equalization fee and debenture plans expected to help the farmer? Explain.
21. Discuss the Federal Farm Board experiment.
22. How did the Emergency Farm Mortgage Act provide debt relief for the farmers? Explain.
23. How did the government attempt to provide further mortgage debt relief for the farmers through the first and second Frazier-Lemke Acts?
24. What was the fate of these measures, and why?
25. Was it desirable to give the farmers debt relief in 1933? Explain.
26. What was the function of the Commodity Credit Corporation, and how was it related to the main program for agricultural adjustment?
27. What was the purpose of the Agricultural Adjustment Act? Explain.
28. What were the principal methods by means of which this purpose was to be accomplished?
29. How did the A.A.A. handle the emergency situation in 1933?
30. Explain the 1934 acreage reduction program, giving as many details as possible.
31. How did actual reductions in acreage compare with the reductions which were contracted for? Explain.
32. How were marketing agreements used by the A.A.A. in controlling certain lines of farm production?
33. Why was the number of "basic products" increased in 1934?
34. What was the nature and eventual fate of the Potato Control Act?
35. How and why was the Agricultural Adjustment Act amended in 1935?

References for Further Reading

See list of references at the end of Chapter 20.

20 AGRICULTURE (*Continued*)

The Results of the Agricultural Adjustment Program

The Effect of the 1934 Program on Production.—The effect of the 1934 agricultural adjustment program upon farm output was obscured to some extent by the great drought of that year. The combined influence of drought and deliberate reduction on the size of certain crops is shown in Table 24. The greater part of

Table 24.—Production of Certain Basic Crops in 1934 and 1935 in Comparison with 1927–1931 Average Production[a]

Commodity	1927–1931 Average Production	1934 Production	1935 Production
Wheat	886,000,000 bu.	526,393,000 bu.	626,344,000 bu.
Corn	2,516,000,000 bu.	1,461,123,000 bu.	2,303,747,000 bu.
Cotton....... ..	13,047,000 bales	9,636,000 bales	10,638,000 bales
Tobacco	1,471,000,000 lbs.	1,081,629,000 lbs.	1,297,155,000 lbs.

[a] Source: *Statistical Abstract of the United States, 1937*, pp. 637–641.

the reduction in corn and wheat was probably attributable to the drought, while in the case of cotton and tobacco it was probably due to the reduction program, since these commodities are produced in states which were not seriously affected by the drought. These final crop estimates for 1934 showed that the cotton crop of that year was the smallest since 1921, the wheat crop the smallest since 1893, and the corn crop the smallest since 1881.[1] Because of the small crops, our surpluses of these products were greatly reduced. For example, on April 1, 1935, stocks of corn were only 40 per cent, and stocks of wheat 19 per cent, as large as those held at that time in the previous year.[2]

The Effect on Prices.—As a result of the smaller crops produced in 1934, the prices of farm products rose considerably. In February, 1935, the Agricultural Adjustment Administration

[1] *New York Times*, January 2, 1935.
[2] *Ibid.*, April 11, 1935.

was able to announce that the January price level of the fourteen basic agricultural commodities, including the seven on which processing taxes were levied, had practically reached the pre-war parity level as a result of the drought and the operation of the agricultural adjustment program. In that month, prices for the fourteen products were 126 per cent of pre-war prices, putting them virtually on a par with non-agricultural prices. In February, 1933, the prices of agricultural products had been only about 52 per cent of pre-war prices [3]

Farm Income.—The increase in the prices of farm products in 1933 and 1934 more than offset the reduction in the quantities produced and sold, so that the gross farm income of the United States increased from $5,337,000,000 in 1932 to $6,406,000,000 in 1933, and to $7,300,000,000 in 1934.[4] The increase over 1932, therefore, was $1,069,000,000 in 1933 and $1,963,000,000 in 1934, or a total of $3,032,000,000 of surplus income over and above the amount the farmers would have received from a continuance of the 1932 level of income. During 1933 and 1934 the total payments to farmers under the Agricultural Adjustment Administration amounted to only $629,600,000, so it is clear that most of the improvement in farm income was not a gift from the government. These benefit payments were well covered by revenue from the processing taxes in the amount of $640,900,000.[5]

The farm situation had improved sufficiently by the beginning of 1935 to make it unnecessary to restrict output as greatly as in 1934. As is shown in Table 24, the output of wheat, corn, cotton, and tobacco all increased considerably in 1935 as compared with 1934. The surpluses had been so well cleaned up, however, that total farm income increased to $8,110,000,000 in 1935, despite the increased production. It is evident that, however the Agricultural Adjustment Administration program may have affected others, it was decidedly beneficial to the farmers of our country, though not all the improvement in farm conditions was attributable to the government's farm program.

An Appraisal of the Agricultural Adjustment Program

We are now in a position to undertake an appraisal of the Agricultural Adjustment Act and its operation. The task is rendered difficult by the fact that most of the widely circulated criticisms

[3] *Ibid.*, February 8, 1935.
[4] *Ibid.*, January 5, 1936
[5] *Ibid.*, February 8, 1935.

of the administration's farm program were political or hysterical (or both) in character. Certain aspects of the program unquestionably merited adverse criticism from the economic point of view, but some of the sins with which the A.A.A. was charged by newspaper and magazine writers were apparently inspired by motives that were not strictly scientific.

"The Worship of Scarcity."—Political writers opposed to the Roosevelt administration shed bitter tears over the untimely demise of sows and little pigs, and the plowing under of growing cotton. Indeed, it seemed to many people to be economically unwise, if not downright irreligious, to destroy economic goods in the process of production, or otherwise to restrict production, when people were going without sufficient food and clothing. But from the long-run point of view it appeared to supporters of the administration that the process of providing jobs for the unemployed and those on relief would be hastened by preventing farmers from raising such huge quantities of basic farm products as to keep down their incomes and make it impossible for them to purchase the products of industry.

It was sometimes asserted that the administration worshiped scarcity for its own sake, and was trying to make the nation rich by producing less of everything. It is obvious, of course, that in the long run a nation becomes prosperous by producing goods in abundance rather than by restricting production. We doubt, however, that the administration or economically informed people in general believed and intended that restriction in agriculture should be a permanent policy. As a temporary expedient, it may have been justified. In a severe depression, with a great industry as badly maladjusted as was agriculture, it may be desirable to practice restriction for a time in order to put the industry once more on an equal footing with other industries. When this has been accomplished, the restrictions should of course be removed, and all industries be encouraged to move forward together toward the goal of producing an abundance of goods.

There is some question, also, as to the extent to which the administration's farm program should have been considered one of restriction. The five-year period, which was taken as a base, was one of unusually heavy production for many of these farm products. If another period had been taken as a base, full normal production, as represented by this base period, might have been permissible, or at the very least the percentages of restriction

might have been much smaller. However, even with the base period which was used, the percentages by which individual farmers agreed to reduce acreage might have been decreased in some cases and increased in others. And when the time came to increase the production of basic crops in general, it might have been possible to apply different percentages of increase in different producing districts, so as to take advantage of the principle of geographical specialization to a greater extent than formerly.

At any rate, many criticisms of the farm program were apparently based upon a confusion of the terms "adjustment" and "reduction." Agricultural adjustment means the reduction of the output of farm products only when reduction is necessary. At other times, it means expansion of output or stability of output. It is difficult to see how the government could have succeeded in raising the prices of farm products and increasing farm income, without attempting in any way to exercise control over farm production. Governmental funds, used to raise farm prices, were likely to be completely wasted if the farmers were left free to produce as large crops as they might wish. Finally, with respect to scarcity, we may suggest that it was rather inconsistent for big business men and captains of industry to criticize the government severely for helping the farmers to adopt the same policy as that followed by the industrialists in every depression—that is, the policy of restriction of output.

The Loss of Freedom of Enterprise.—Much of the criticism leveled against the Agricultural Adjustment Act was based upon the so-called "regimentation" of farmers, and the loss of traditional American freedom of enterprise. Apparently the critics felt that every person should be free to become a farmer if he liked, and to raise as much as he wished of any product, even if the result was his economic downfall. Supporters of the administration, however, thought it fair to question the benefits of freedom of enterprise to the farmer. It was under the "protection" of this institution that those engaged in farming chose to be and remain farmers, despite unfavorable conditions in this industry, and it was under this same institution that they raised basic products in such quantities as to bring themselves to the verge of ruin in the great depression.

If we may judge by the response of the farmers to the administration's agricultural program, it would seem that the vast majority of them were willing to forego a considerable measure of

freedom of enterprise in return for improved prices and incomes. An objection which might be raised to this conclusion is that we do not know just how much pressure may have been brought to bear upon the farmers by federal agents, in order to get them to sign their individual contracts with the Secretary of Agriculture, or how many farmers agreed to accept benefits and restrict production because they felt they had to do so in self-defense, since other farmers were joining in the movement. In any case, this type of criticism had but little force, if the farm program was intended as a temporary measure.

The March Toward Socialism.—One of the chief criticisms of the administration's agricultural program was the tendency, clearly evident under the A.A.A., to increase the number of products to be brought under the provisions of the program as time went on. This increase may be illustrated by reference to certain sections of the South. When individual growers rented a part of their cotton or tobacco land to the Secretary of Agriculture, they had to agree not to use it for producing other basic products, such as rice; and it is not surprising that some turned to raising sugar or peanuts, when their land was suitable for such production. As a result, the price situation for growers of these articles was adversely affected, and so, in 1934, sugar and peanuts were included in the program of the A.A.A.

With five products, usually associated with the South, already under production control, in what way could the farmers use their restricted acres? There was probably no unanimity of action, but it is probable that some farmers in the South and elsewhere turned to raising potatoes. At any rate, so many potatoes were grown that some were left to rot in the ground in Maine and other areas traditionally planted to this crop. The result was the passage, in 1935, of the law for potato control. The critics held that as time went on more and more products would come under control until all agricultural production became socialized. They predicted that the movement would then turn to manufactured products, beginning perhaps with articles made from imported materials such as silk, which might compete with manufactured goods made from basic farm materials controlled by the A.A A. They went so far as to urge that there would be no end to the process short of complete socialism.

Disclaiming all responsibility for the way in which these critics employed the term "socialism," let us examine their argument. It

might be admitted that a permanent policy of control in some lines of production would tend to spread to other lines, and perhaps with undesirable results. But a policy of temporary control need not lead to permanent governmental control of all lines of production; and the A.A.A. program must be thought of as a temporary expedient. The governmental control of prices in this country during the World War also showed a tendency to spread to more and more articles, but it was possible to drop the whole program of price control, once the emergency was over. Arguments by analogy are dangerous, but at no time was there reason to suppose that our agricultural control program had started us on a march toward "socialism" from which there was no turning back.

The Mythical Farmers.—Much publicity was given to newspaper articles describing the payment of benefits to farmers for not raising products which they had no intention of raising. One story of this kind told of a southern farm tenant who raised cotton in some quantity. Just before the benefit payments began, the owner of the farm dispossessed his tenant. Though the owner himself had never raised any cotton he was said to have been receiving benefits year by year for not growing cotton. There is another popular tale of the man who lived in various places, if we may accept the many versions of the story, and who used to feed hogs on the garbage collected through the exercise of a concession which he held. About 1933, he lost this garbage concession and as a consequence was retiring from the hog-raising business; but making a virtue of necessity, he proceeded to draw benefits regularly for agreeing to raise no more hogs. These particular tales may or may not be based on fact. With millions of contracts to be drawn up with individual growers, it would be surprising if there were not some instances of this kind. But it would be childish to conclude that such cases were typical of the activities of the A.A.A. Supporters of the farm program claimed that the Administration was very economical in drawing up its contracts. For example, the average 1933 yield of cotton in the United States was estimated at more than 205 pounds to the acre, but the withdrawn acres, rented by the government, were taken at an estimated 184 pounds to the acre. This low average was achieved despite the fact that the Agricultural Administration leased no land estimated to yield less than 100 pounds to the acre, and no flooded or drought-affected land.

The Farmers' Income.—When the Agricultural Adjustment Act was passed, many people doubted that the income of the farmers would be increased substantially by the program. It was expected, to be sure, that farm prices of basic products would increase; but the farmers' income depends, of course, upon prices times quantities sold. With prices to consumers raised by both reduced production and the processing taxes, it was thought that the quantities taken by consumers might fall off to such an extent that the farmer would not gain much despite the higher prices and cash benefits received. However, the statistics for farm income since 1933 leave no doubt that total farm income increased materially under the A.A.A.

The A.A.A. *vs.* Other Administration Policies.—It was also argued that the program for agricultural adjustment conflicted with other policies of the Roosevelt administration—notably the attempt to increase purchasing power for consumers in general—since prices of controlled products would probably rise by more than the increase enjoyed by the farmers. This argument did not prove valid, since the farmers received benefits to offset the processing taxes and greater receipts to offset the rise in prices caused by restricted production. Hence, the only net decrease in consumers' income would seem to have been that part of the collections from processing taxes which went into paying the expenses of administering the farm program, rather than into benefits for the farmers.

It was thought, also, that total consumers' purchasing power might be reduced by reason of farmers using their income increases to pay off debts, rather than to purchase finished goods; whereas if the additions to income had not been taken away from other consumers, they would have been used to buy consumers' goods. But the indexes of farmers' purchases that we have, such as sales by mail-order houses and sales of automobiles in rural areas, seem to indicate that the farmers used no small part of their increased incomes for the purchase of finished manufactured products. And even if they did pay off old debts instead, how would their creditors use these payments, if not for the purchase of economic goods?

According to Secretary of Agriculture Wallace, the farm program was beneficial to consumers, as well as to farmers, since it was aimed to restore a "fair exchange value" for farm products and to enable farmers to purchase other goods. He insisted that

consumers gain nothing in the long run by getting farm products at less than the cost of producing them. Agriculture, he said, is an essential industry which must be maintained, and to this end the prices of farm products must be kept sufficiently high to cover costs of production. He argued that consumers do not escape this necessity when for a time they fail to pay these necessary prices, but simply postpone the payment to their own disadvantage.[6]

There was some strength, however, in the criticism that the A.A.A. program conflicted with the attempts of the administration to bring about recovery in manufacturing industries. The processing taxes, through which the funds were raised to pay benefits to farmers, were levied on the first processors of the farm products. They therefore operated to bring increased costs to manufacturers, and may have been a stumbling block to recovery in industries using basic farm products as raw materials.

Class Legislation.—We now turn to certain criticisms which appear to be more serious from the economic point of view. One may properly question whether it is wise at any time for the government to support a particular industry at the expense of other sections of our population and, in this case, to pay the farmers to do something which it would have been to their interests to do in any case. Under the A.A.A. the consumer was taxed (if the processing taxes were shifted to him) in order to pay the farmer to restrict production and thus be enabled to charge the consumer higher prices. Clearly, the Agricultural Adjustment Act was legislation intended to benefit one class of people at the expense of others.

According to administration supporters, the wisdom of class legislation depends, at least in part, upon the length of time during which the policy of discrimination is followed. An economist who would condemn a policy of this kind as a permanent feature of our economic system might tolerate it as an emergency measure. At any rate, said the supporters, it must not be supposed that this is our first experience with legislation that benefits some members of the community at the expense of others. Our protective tariff legislation, which economists have been condemning for decades, does much the same thing, in that it benefits certain people (the owners of the protected industries) at the expense of those who are consumers. Surely it is the height of inconsistency to praise

[6] *Yearbook of Agriculture, 1935,* p. 5.

the protective tariff and at the same time to condemn the farm program on the ground that it is class legislation.

The Processing Taxes.—Was it wise to secure the funds required for the payment of benefits, by levying taxes upon the first processors of basic agricultural products? Might it not have been better to obtain this necessary revenue in some other way, so that the farmer could have received the entire benefit of the increased prices which resulted from restriction of output? In theory, at least, it would probably have been desirable to secure the revenue in some other way (say from income taxation) in order to help the farmers more extensively and to interfere less with the recovery of manufacturing industries; and also because processing taxes, if shifted to consumers, fall more heavily upon the poor than upon the rich. That is, these processing taxes were regressive. In practice, however, the receipts from income taxes and other progressive taxes are not always sufficiently elastic to produce adequate revenue in years of depression, so that it may have been necessary to use processing taxes, or other taxes similar in nature, to insure the collection of sufficient revenue.

The Administrative Problem.—There is no doubt that the farm program presented a difficult problem in administration. It would have taken a tremendous amount of supervision to make sure that all of the millions of individual farmers actually restricted their acreage by the promised amounts, that they did not turn to raising other basic products, and that they did not offset the effects of acreage reduction by cultivating their remaining land more intensively. It would seem that opportunities for petty graft abounded under the A.A.A.

Our Exports and the A.A.A.—We have noted that both the basic farm products, and the manufactured articles made from them, were exempt from the processing taxes when they were exported. However, the prices of the exported basic products were raised by the restriction of production, and the costs of exported manufactured goods were raised, in all probability, by their dependence upon raw materials which had risen in price. Thus, our export trade was adversely affected by the farm program, and the production of the basic products in other parts of the world was stimulated to some extent.

Our cotton exports in 1934 were only 4,799,000 bales, as compared with 8,419,000 bales in 1932, and an annual average of 8,250,000 bales from 1925 to 1929. Wheat exports, which were

97,000,000 bushels in 1932 and averaged 133,000,000 bushels from 1925 to 1929, were only 19,000,000 bushels in 1934 and 3,000,000 bushels in 1935. Exports of corn amounted to 2,000,000 bushels in both 1934 and 1935, a considerable decline from 9,000,000 bushels in 1932 and an average of 23,000,000 bushels from 1925 to 1929. Tobacco exports were 473,000,000 pounds in 1934, but declined to 353,000,000 pounds in 1935, as compared with 432,000,000 pounds in 1932 and an average of 508,000,000 pounds from 1925 to 1929.

This decline in exports, however, did not seem so serious to supporters of the farm program as to some other people. Since, from the national point of view, the purpose of exporting is to become able to import, and since our imports are severely curbed by our protective tariff, a decline in exports may prevent us from making further foreign loans or getting into other difficulties in the field of international trade. Moreover, if the farm program did result in a decline in our exports of farm products, it merely continued a movement which had been in progress for many years because of our tariff policy.

The Permanence of the Farm Program.—Probably the most serious criticism of the farm program was the charge that the A.A.A., once instituted, could not be given up and would turn into a permanent policy. It can scarcely be stated too emphatically that the agricultural adjustment program was not desirable as a permanent solution of the farm problem in the United States, because it did nothing to reduce the number of farmers in the country or the amount of land available for the production of the basic crops. When the demand for a manufactured product suffers a permanent decline, the industry reacts by producing fewer units than formerly and by allowing a part of its productive facilities to lie idle. Eventually, however, the industry tends to readjust its productive capacity to the changed conditions of demand, and only then can it be said to have met the problem created by the decline in demand. The A.A.A. program led only to the first of these steps, that is, it induced the farmers to produce less than before and to allow a part of their productive agents to remain unused. It did not lead to the apparently necessary curtailment of the land, labor, and capital employed in the agricultural industry.

The Secretary of Agriculture realized perfectly well that the A.A.A. was merely an emergency measure, that it took out of

cultivation land which was efficiently cultivated as well as land which was not, and that it did not control satisfactorily the bringing of new land under cultivation and the shift of production on government-leased acres to non-basic products. According to the Secretary, the temporary and varying reductions in acreage under the A.A.A. seriously disturbed the farm economy, for it upset established rotations of crops and the relations between landlords and tenants. He suggested that it was more costly to induce farmers to keep a part of their acreage out of cultivation than it would have been to rent a corresponding acreage made up of whole farms. The purchase of submarginal land by the government would probably have been still better.[7]

Despite the fact that many, if not most, people felt that the A.A.A. should be merely a temporary program, there was always a possibility that it might be continued indefinitely. Once the government had established the practice of paying cash benefits to the farmers, it threatened to be a most difficult matter, from a political point of view, to discontinue these benefits when it became economically desirable to do so. Hence, we were in some danger of seeing the farm program remain as an undesirable but permanent feature of our economic system, in much the same way that the protective tariff, created more than a century ago to protect infant industries, has remained to plague us long after some of these infants have become industrial giants.

The End of the Agricultural Adjustment Program.—Arguments as to the wisdom or folly of the agricultural adjustment program came largely to an end in January, 1936, when the Supreme Court found the Act unconstitutional by a 6 to 3 vote. It was held that the law constituted an invasion of states' rights, since the Constitution did not give the federal government the power to regulate agriculture, and its power to control interstate commerce could not be stretched to include the regulation of agricultural production. Moreover, it was held to be improper for the federal government to purchase compliance with a federal program, and thus attain indirectly that regulation of local affairs which had been specifically denied it by the Constitution. While agriculture can hardly be considered a matter of local concern from an economic point of view, it appears to be purely so according to this interpretation of the Constitution.

[7] *Yearbook of Agriculture, 1934*, pp. 20-22.

The Soil Conservation Program

The Soil Erosion Problem.—Since the federal government was unwilling to see American agriculture return to its previous chaotic state and since no permanent solution of the farm problem had been found, the government launched forth upon the discovery of a new farm program. In its search, it came upon the problem of soil erosion, upon which we commented in the preceding chapter. Satisfactory methods of combating soil erosion have been developed. Several types of close-growing vegetation, such as grass and alfalfa, are helpful in holding the soil in place and reduce water and soil losses very materially. Amazing results may be achieved merely by rotating such soil-conserving crops with the money crops, such as corn and cotton.

Results of Vegetation Control.—The Department of Agriculture has collected much information showing how vegetation may be used in preventing soil erosion. On an experimental plot near La Crosse, Wisconsin, where the soil loss was 51.5 tons to the acre when the soil was uncultivated and 59.9 tons to the acre when planted to corn continuously, it was found that the loss could be reduced to .003 of a ton per acre by planting the land to bluegrass continuously. On another plot near Bethany, Missouri, where the soil loss was 112.48 tons to the acre when uncultivated and 61.16 tons to the acre when planted to corn continuously, the loss was decreased to .22 of a ton per acre by planting to alfalfa continuously. In the La Crosse experiment, the loss of water was 15.9 per cent of rainfall when the land was uncultivated, 19.2 per cent when used for corn continuously, and only 2.9 per cent when planted to bluegrass continuously. On the Bethany plot, the water loss was 25.98 per cent of rainfall on uncultivated soil, 27.38 per cent when planted to corn, and only 3.40 per cent when planted to alfalfa continuously. Finally, in a third experiment, it was discovered that soil loss could be reduced from 28.0 to 6.3 tons per acre, and the rainfall loss from 14.2 to 11.7 per cent, by rotating cotton, wheat, and sweet clover instead of using the land continuously for cotton.[8]

Other Control Methods.—A method known as strip-cropping is also helpful in preventing soil erosion under favorable conditions of cultivation. Strip-cropping means the alternation of close-growing crops with the money crops, such as corn or cotton, in

[8] *Yearbook of Agriculture, 1935,* pp. 299-305.

strips of a certain width, depending on the degree of slope and other factors. This method of controlling soil erosion often requires help from mechanical methods, especially on the steeper slopes, for the land is in danger from erosion whenever it is planted to cultivated or money crops. In such cases, methods such as terracing the land and using broad, contoured channel ways for drainage have often proved helpful in reducing sheet erosion and severe gullying.

The chief difficulty with erosion control in the past has been to get the farmers actively interested in it. The individual farmer has often felt that he could do little about soil erosion by himself, or has lacked the financial resources which would permit him to make the attempt. Under unfavorable farm conditions in the past, farmers have considered it necessary to use all of their land for money crops and to keep it planted to such crops year after year, in order to make ends meet. In 1936, the government decided, after the A.A.A. was declared unconstitutional by the Supreme Court, to undertake a program of erosion control which would also help to solve the main farm problem.

The Soil Conservation Act.—Consequently, in February, 1936, a previously existing Soil Conservation Act was amended and enlarged for this purpose. The Act appropriated about $500,000,000, and authorized the Secretary of Agriculture to restore the pre-war relationship between farm and city incomes for those farmers who should comply with prescribed methods of soil conservation and erosion control. For two years, the government was to make payments directly to cooperating farmers, as a reward for their voluntary support of the program of soil conservation. Beginning with 1938, however, federal payments were to be made only to persons in states which had passed authorizing legislation and had formed a conservative plan acceptable to the Secretary of Agriculture.

In the administration of the law, two classes of benefit payments are available for farmers who cooperate. Payments for soil conservation are granted to farmers for transferring a part of their soil-depleting base acreage to soil-conserving crops or uses. Farmers may obtain this type of payment on any number of acres up to 15 per cent of their general soil-depleting base acreage, 35 per cent of their cotton base acreage, 30 per cent of their tobacco base acreage, and 20 per cent of their peanut base acreage. The payments are on a basis of so much an acre, and average about

$10 an acre for the country as a whole. The other payments are called soil-building payments, and are available for farmers who adopt certain approved practices to restore soil fertility, such as new seedings of legumes or perennial grasses; seeding soybeans, cowpeas, and the like, for green manure; the application of limestone; and the use of strip-cropping or terracing methods. Such payments are limited to the same number of dollars as a farmer had acres of soil-conserving crops on crop land in 1936.[9]

The relation of this conservation program to the main farm problem is obvious. If the farmers use a part of their land for crops which will be effective in preventing soil erosion, they cannot use it for producing the basic money crops. In this way, it is planned to kill two birds with one stone—to achieve some highly desirable results by way of controlling soil erosion, and at the same time to prevent the overproduction of the basic crops.

1936-1937 Results.—The soil conservation program was in operation in 1936, but its effects on agricultural production were obscured by the great drought of that year—a drought second only to that of 1934, which was said to be the worst in American history. The 1936 drought reduced some basic crops substantially, as is shown in Table 25. The cash income of our farmers, which

TABLE 25.—PRODUCTION OF CERTAIN BASIC CROPS IN RECENT YEARS[a]

Year	Wheat (bushels)	Corn (bushels)	Cotton (bales)	Tobacco (pounds)
1934	526,393,000	1,461,123,000	9,636,000	1,081,629,000
1935	626,344,000	2,303,747,000	10,638,000	1,297,000,000
1936	626,461,000	1,529,327,000	12,399,000	1,153,083,000
1937	875,676,000	2,651,284,000	18,946,000	1,552,601,000
1938	930,801,000	2,542,238,000	12,008,000	1,455,970,000

[a] Sources: *Statistical Abstract of the United States, 1937*, pp. 637–641, and *Chicago Tribune*, December 19, 1938.

was $6,387,000,000 in 1934, and $7,090,000,000 in 1935, increased, because of high prices, to $7,850,000,000 in 1936. In 1937, weather conditions were favorable, and the output of most basic farm products was large. However, prices were well maintained, and the farmers' cash income increased further, to $8,500,000,000.[10]

[9] *Yearbook of Agriculture, 1937*, pp. 16, 17.
[10] *Statistical Abstract of the United States, 1937*, pp. 606-609.

An Estimate of the Soil Conservation Act.—It seems likely that the Soil Conservation Act has a better chance for survival than the old Agricultural Adjustment Act. It has the advantage of being planned to operate eventually as a state program, carried on with financial assistance from the federal government. This method of procedure has proved to be constitutional in the past in other connections, as, for example, in the construction of highways. Under the soil conservation plan, the farmer is not paid for *not producing* the basic crops. Rather, he is paid for taking positive action in cooperating in a national program of soil conservation, and any restriction of output that may occur comes about indirectly. Moreover, the financing of the plan is not dependent upon a system of unpopular processing taxes. The control of soil erosion is a pressing problem, and one which is undoubtedly national in scope. Therefore, this may be judged a proper sphere of action for the federal government.

Otherwise, the Soil Conservation Act is open to many of the criticisms raised against the Agricultural Adjustment Act. It tends to make the basic farm products scarcer than they would otherwise be, and causes farmers to take a course of action which they would not have followed on their own initiative. It presents similar administrative difficulties, and tends to conflict with other policies of the administration. It is not quite so widely open to attack on the grounds of class legislation, since the problem of soil erosion is important to everyone; but it tends to keep the domestic prices of our farm products above the world prices, so that our exports of these products remain at low ebb. Finally, the program may be continued far into the future, regardless of our future need for erosion control, because of its indirect effects on farm production.

These criticisms assume that the soil conservation program will succeed in controlling agricultural production, but this premise may be seriously questioned. The Secretary of Agriculture has stated that the Soil Conservation Act helped to stabilize supplies of farm products in 1936, by encouraging the more extensive use of land. But he recognized that the Act was not a direct measure for production control, and predicted that the return of normal weather conditions would bring the problem of agricultural surpluses back to life. This prediction was borne out to some extent in 1937 and 1938. We should note, also, that the

long-run effect of soil conservation will be to increase, and not to decrease, agricultural production.

Recent Developments and the Future

The Farm Act of 1938.—Early in the 1937-38 business recession, the prices of farm products in general slumped badly. With substantial reserves of the basic products on hand (as a result of the large crops in 1937), and with the probability of very large, if not record, crops in 1938, it appeared that further farm legislation was necessary, and so Congress approved a new Farm Act in February, 1938. This Act provided for the continued operation of the Soil Conservation Act in normal times. In years of overproduction of farm products, however, a rather stringent method of control goes into effect.

Marketing Quotas.—According to this law, there is "overproduction" whenever the corn crop and "carryover" exceed 2,795,000,000 bushels; the wheat crop and carryover, 945,000,000 bushels; the cotton crop, 19,500,000 bales; or whenever the rice crop is 10 per cent, or the tobacco crop 5 per cent, greater than normal. When there is overproduction of one of these commodities, the Secretary of Agriculture may set up compulsory marketing quotas, after receiving the approval of two-thirds of the producing farmers voting in a referendum. The amount of the total marketing quota is to be equal to a year's normal consumption and exports, plus a certain percentage, minus the estimated carryover at the beginning of the marketing year and the amount received as seed or for livestock. The total marketing quota is prorated to states, counties, and individual farms, in proportion to normal yields of their acreage. For the individual farmer, the marketing quota is the amount of a commodity that he may sell without penalty.

Acreage Allotments.—Control of agricultural production is also to be facilitated by acreage allotments. These acreage allotments are not compulsory in themselves, but they furnish the basis for setting up the marketing quotas, and farmers who produce and sell the basic products in amounts exceeding their marketing quotas must pay penalties, on the excess, of 15 cents a bushel for corn and wheat, and 2 cents a pound for cotton. Moreover, basic commodities produced in excess of marketing quotas may not be fed to livestock for the market, given away, or traded for other economic goods. They have to be stored on the farm or in warehouses. The acreage allotments for each commodity are also

made by the Secretary of Agriculture, and equal altogether the acreage required to produce a year's normal requirements for consumption and export, plus an arbitrary amount for stocks, minus the amount carried over from the preceding year.

Crop Loans.—The Act provides for loans to farmers on their excess supplies of the basic products. The Commodity Credit Corporation is directed to make loans on wheat, when the price is below 52 per cent of parity, or when the estimate of the current crop is larger than the amount of a normal year's consumption and exports. The parity price for a good, as under the A.A.A., is one which will give that commodity a purchasing power (in terms of the goods which farmers buy) equal to its purchasing power in the base period which, for most of the goods, is the period from 1909 to 1914. The amount loaned on wheat may vary between 52 and 75 per cent of the parity price.

Loans on corn are made whenever the price is below 75 per cent of parity, or when the crop estimate exceeds a normal year's consumption and exports. These loans may also vary in amount from 52 to 75 per cent of the parity price. Cotton loans are made on terms identical with those for wheat loans. All of these loan rates apply only to "cooperators," that is, to farmers who comply with the requirements of the program as prescribed by the Secretary of Agriculture. "Non-cooperators" get no loans at all, or much smaller loans than those granted to cooperators. It is provided, further, that no loans need be made on a commodity produced by those who, voting in a referendum, reject the imposition of marketing quotas for that commodity. In view of these provisions, a high degree of cooperation with the Secretary of Agriculture was expected from American farmers.

Since the 1938 wheat crop, plus carryover, was certain to exceed a normal year's consumption and exports, a program of wheat loans was put into effect early in 1938. These loans averaged about 60 cents a bushel, and the wheat used as collateral had to be held either in commercial warehouses, or in approved granaries or bins on the farm. The loans will bear 4 per cent interest, and will run for seven months in the case of commercially stored grain, or until May 31, 1939, in the case of wheat held on the farm. Farmers who did not exceed their acreage allotments for soil-depleting crops by more than 5 per cent, were eligible for these loans. Farmers may regain possession of their wheat at any time by repaying the loan, plus interest and storage charges. When the loans mature,

the farmers have the privilege of surrendering their wheat to the government as full payment of their obligations.

In the fall of 1938, corn loans of 57 cents a bushel were made available for farmers in the commercial corn area of the Middle West. It was expected that many such loans would be taken out, since the loan rate was about 10 cents a bushel above the market price for corn. Farmers were able to obtain these loans, let the government keep the corn as security, and buy corn for their own feeding from non-cooperators at the low market price. Corn loans for farmers outside the commercial area were set at 43 cents a bushel, while non-cooperating farmers were entirely ineligible for loans.[11]

Crop Insurance.—Besides continuing the Soil Conservation Act, the new Farm Act provided for crop insurance for wheat only, beginning with the 1939 crop. A federal crop insurance corporation was set up, with capital of $100,000,000 and a 1939 appropriation not to exceed $20,000,000, to insure wheat against losses due to drought, flood, lightning, tornado, hail, winterkill, wind, plant disease, and insect infestation. The insurance may cover from 50 to 75 per cent of the average yield on a farm, over a representative period of time. Reports in December, 1938, indicated that 234,485 farmers had applied for insurance on the 1939 wheat crop, and that 103,000 had already paid their premiums in wheat turned over to the government.[12]

The 1938 Wheat Program.—Because of the falling prices of farm products and the large 1937 crops, it was thought desirable to put the new Farm Act into immediate operation. The 1938 wheat program called for a reduction from 81,000,000 to 62,500,000 acres. Farmers who planted within allotments received soil conservation benefits of 12 cents a bushel on the normal yield of the planted acres. Every acre planted in excess of allotments was to be penalized at the rate of 96 cents a bushel on the normal yield, the penalties to be deducted from the benefits. Land taken from wheat production must not be put into other soil-depleting crops. No acreage allotments were made to farmers whose normal wheat production for market is less than 100 bushels.[13]

The 1938 Corn Program.—The area planted to corn was cut from 99,000,000 to 94,000,000 acres, under the 1938 program.

[11] *Chicago Tribune,* November 11, 1938.
[12] *Champaign-Urbana (Illinois) News Gazette,* December 4, 1938.
[13] *Champaign-Urbana (Illinois) News Gazette,* February 28, 1938.

Benefit payments for allotted acres were 10 cents a bushel on the normal yield, while a penalty of 50 cents a bushel was to be assessed on the normal yield of every acre planted in excess of allotments.[13] It was expected that a vote would have to be taken among corn growers, to decide the question of marketing quotas, but the Secretary of Agriculture apparently decided to avoid the referendum by revising the estimate of the corn crop downward.

The 1938 Cotton and Tobacco Programs.—The 1938 cotton program called for the planting of 27,000,000 acres, as compared with 44,000,000 acres which were once planted in cotton. Through this reduction, the 1938 crop was held down to about 12,000,000 bales, or approximately enough for this year's consumption and exports. The immense carryover of 13,000,000 bales from 1937's record crop will probably not be reduced, however. It was expected that loans of about 9 cents a pound would be made, eventually, on about 5,500,000 bales of the new crop.[14] Tobacco growers, also, had a control program for 1938 which included, among other things, the production of 705,000,000 pounds of bright, flue-cured tobacco, and a penalty of 50 per cent of the market price on tobacco sold in excess of marketing quotas.[15]

Appraisal of the 1938 Farm Act.—An elaborate program, under the 1938 Farm Act, has been worked out for 1939, but it seems unnecessary to give the details of this program, since it appears probable that the Act will be changed during the 1939 session of Congress. The 1938 allotments were not received with very good grace by the farmers. From various parts of the country came reports that farmers were up in arms, or near revolt, because of the allotments given them; and charges of favoritism and double-dealing with respect to allotments were heard as between states, counties, and individual farmers. Of course, it is difficult to know how much of this alleged unrest was real and how much merely represented wishful thinking on the part of anti-administration newspapers. But it served at least to call attention to the fact that the 1938 Farm Act is exceedingly difficult to administer, in both making and enforcing the plans. The Act is long and complicated, covering as it does some fifty pages of fine print; and it has been remarked facetiously that a farmer will need to send his son through law school if the son is to be a successful farmer himself.

[14] *Chicago Tribune,* May 18, 1938.
[15] *Ibid.,* May 4, 1938.

In the fall of 1938, it was necessary to hold referendums among growers of several crops, on the question of marketing quotas for 1939. Such quotas were approved by cotton growers, but were rejected by three groups of tobacco growers and by rice growers. These unfavorable votes may lead to a revision of the Farm Act. Indeed, a new bill has already been introduced into Congress, calling for governmental price-fixing, at the average cost of production level, on such amounts of important crops as are needed for the domestic market, and for surpluses of these crops to be turned over to the Secretary of Agriculture for marketing abroad at the best prices obtainable.

The 1938 Farm Act was superior to the Agricultural Adjustment Act in that it depended upon general revenues, rather than processing taxes, for funds. Otherwise, it was quite similar to the A.A.A., except that it seemed to be more highly restrictive. Practically every criticism formerly leveled at the A.A.A. may be applied to the 1938 Farm Act. Many people have held that the new Act is clearly unconstitutional. This is always a hazardous sort of prediction; but it may be said that, if this Act survives the test of constitutionality, it will be because of a changed temper on the part of the Supreme Court since the rendering of the A.A.A. decision, and not because of any inherent superiority of the new Act.

The Permanent Solution.—It is unpleasant to have to suggest that the 1938 Farm Act, like the two Acts which preceded it, apparently does not provide a long-run solution of the farm problem. It sets up a complicated mechanism which may work successfully in adapting the *rate of operation* in agriculture to the demand for the products, but this is a short-run type of adjustment. If the present program should be discontinued after a few years, the main farm problem would probably arise again with undiminished vigor. A long-run solution requires the adjustment of the *size* or *capacity* of agricultural production as a whole, and not merely its rate of operation, to the demand for farm products—and the new Act does nothing to decrease the number of farmers or to reduce their land holdings available for growing the basic crops.

The new plan should be supplemented with a careful study of land uses in the United States, to ascertain the purposes for which land in various parts of the country may best be employed. The main farm problem, it will be remembered, resulted from an expansion of farming to the point at which it could provide heavy

exports after taking care of domestic needs, followed by the loss of foreign markets and changes in domestic conditions to which the productive facilities of agriculture have never become adjusted. Therefore, it is frequently suggested that the federal government should buy up, in different parts of the country, marginal land, which was formerly devoted to the cultivation of the basic crops, and retire it from production permanently or until it is once more needed. It may be necessary, also, for the government to develop agencies which will facilitate the movement of workers from farming into other occupations, in case farmers can be found who are willing to accept such assistance. These transfers would be well-nigh impossible in a period of depression, but could be accomplished eventually. It may be desirable, finally, for us to use less land for production and more for consumption, developing more national parks and using land more extensively as sites for homes.

Fortunately, progress is already being made along some of these lines, for the Resettlement Administration has begun to acquire poor farming land and is promoting its development for other uses. In 1936, for example, this agency obtained options on 9,500,000 acres of poor farm land in 207 projects. Most of the options were taken up at about $4.50 an acre. The new uses for the land included forty-six recreational projects, thirty-two for the propagation and protection of migratory waterfowl, and thirty-one for the Indian service, all of which gave employment to 55,000 relief workers.[16]

The Tariff and the Farm Problem.—If our traditional tariff policy should be thoroughly reversed in the reasonably near future, it might not be too late to recapture some part of our former export markets for farm products; and this achievement would lessen the need for taking the steps that we have just recommended. Our present policy with respect to the tariff, under the Reciprocal Trade Agreement Act, offers some hope in this direction. Farmers should not be too quick to believe newspaper statements to the effect that the trade agreements are disadvantageous to them, because of increased imports of farm products into the United States in recent years. Most of these imports resulted from causes quite unrelated to the reciprocal trade agreements, and, while large in absolute amounts, have almost always constituted an insignificant fraction of production.

[16] *Yearbook of Agriculture, 1937*, p. 23.

Monopolies and the Farm Problem.—It seems, also, that a permanent solution of the farm problem depends largely upon solving the problem of monopolies and trusts. In the past, our farmers have been handicapped by having to sell their products in a highly competitive market while doing most of their buying in a market which is to a considerable degree monopolized, or at least controlled. In the long period of good business prior to 1929, many of our manufacturing industries, being monopolistic or semi-monopolistic in character, were able to maintain stable prices in the face of improved methods of production and falling costs of production. Quite apart from the effect of this situation in producing the depression of 1929, it made it difficult, if not impossible, for our farmers to get prices for their products which would enable them to share in the general prosperity of business.

Later, when the great depression broke in 1929, these monopolistic and semi-monopolistic industries were still able to maintain prices to a very large extent. This they did by restricting production sharply, by turning off employees, and by reducing their purchases of raw materials. This course of action made it difficult for farmers to sell their raw materials and foodstuffs, and the uncontrolled prices of farm products had to bear the brunt of the depression liquidation. Thus, in a sense, the farmers under the various farm programs are only giving our industrialists a taste of their own medicine. The farm problem would have been much less severe if competitive conditions had been maintained in industry, and its solution in the future will be easier if the trust problem is solved successfully.

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1. How was the size of basic crops affected by the A.A.A. program of 1934?
2. What happened to the prices and stocks of farm products under the Agricultural Adjustment Administration?
3. How were farm incomes affected by the operation of the Agricultural Adjustment Administration?
4. Did the Roosevelt administration, through the A.A.A., attempt to enrich the nation by making all kinds of economic goods scarce? Explain.
5. Comment on the distinction between agricultural adjustment and agricultural reduction.
6. How did the farmers react to alleged attempts to "regiment" them, through the A.A.A.? Why?

7. Would the A.A.A. program have eventually led to complete socialism? Explain.
8. Was the Agricultural Adjustment Administration extremely wasteful in carrying out its program? Explain.
9. Why was the agricultural adjustment program said to be in conflict with other policies of the Roosevelt administration? Explain.
10. Do consumers sometimes buy farm products at prices too low for their own good? Why?
11. Why was the Agricultural Adjustment Act called class legislation? Was it to be condemned on this account? Why?
12. Should the revenues for supporting the farm program have been derived from processing taxes? Why?
13. Could the A.A.A. program have been successfully administered?
14. How were our exports affected by the farm program? Why?
15. What was the principal danger in connection with the Agricultural Adjustment Administration? Explain.
16. On what ground was the A.A.A. program declared unconstitutional by the Supreme Court?
17. How can soil erosion be controlled by the use of certain types of vegetation? What results have been achieved by this method?
18. What other methods are employed for controlling soil erosion?
19. What are the chief provisions of the Soil Conservation Act?
20. Explain the dual purpose of this Act.
21. Was the soil conservation program superior or inferior to the A.A.A. program? Why?
22. Why was new farm legislation passed in 1938? Explain.
23. Compare the provisions of the Farm Act of 1938 with those of the two preceding farm Acts.
24. Does the Farm Act of 1938 offer a satisfactory, permanent solution of the main farm problem? Why?
25. What steps should be taken in the near future with respect to agriculture? Why?
26. In what way is the farm problem related to the trust problem? Explain.

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21 TRANSPORTATION

SPECIALIZATION AND LARGE-SCALE PRODUCTION ARE FUNDAMENTAL CHARACTERISTICS OF THE PRESENT ECONOMIC ORDER. An individual does not attempt to produce for himself all of the many economic goods he needs for the satisfaction of his wants, but instead specializes in a single task or a limited number of tasks, trusting that he may obtain, through the process of exchange, the other economic goods that he desires—goods which have themselves been produced for the most part on a large scale by other groups of specialists. Large-scale production brings with it many economies, but we often hear it said that the extent to which large-scale production (and its accompanying principle of division of labor) can be applied is largely limited by the size of the market for the products. The extent of the market is in turn greatly dependent upon the adequacy and efficiency of the means of transportation which have been or can be developed.

The Importance of the Railroads.—In the United States, as in other industrially advanced countries, the railroad was for many years the most important single means of transportation. In 1937, there were 239,112 miles of railroads in this country, counting only single trackage between any two points, as compared with a total of 254,037 miles in 1916. If second, third, fourth, and other trackage is included in the total, the figure for 1937 was 415,399 miles. The total investment in our Class I railroads (which means every railroad that has a net operating revenue of at least one million dollars per year), including the investment in road and equipment, materials and supplies, and cash, amounted to about $26,000,000,000 in 1935. The same group of roads employed 1,065,624 workers in 1936, as compared with 2,022,832 employed in 1920. Finally, the Class I railroads originated about 958,830,000 tons of revenue freight in 1936, as against an average of 1,279,197,000 tons from 1926 to 1930, and carried revenue freight amounting to 339,246,000,000 ton-miles in the same year, as compared with an average of 427,234,000,000 ton-miles in the

years 1926 to 1930.[1] The term "freight originated" refers to freight received from shippers, and does not include freight received from another railroad.

Clearly, it is of importance to everyone that an industry of such magnitude and such vital importance in our economic system should be kept strong and vigorous, and capable of rendering cheap, efficient service. And yet, since the beginning of the great depression of 1929, and even before, our railroads have not been able to earn sufficient net revenue to enable them to maintain existing plant and equipment satisfactorily and attract sufficient new capital to make possible the new construction projects and betterments in general which are so necessary for continued efficient operation. Indeed, many railroads have failed to meet their obligations and have gone into receivership, while our railroads as a whole have operated at a net deficit, after paying interest charges, for several consecutive years. How were the railroads brought to such a condition? What can be done to improve their lot? These are the questions which we examine in the present chapter, and, in doing so, we shall find it necessary to delve into the affairs of the other forms of transportation in the United States. But our first task is to consider the chief economic characteristics of the railroads.

Economic Characteristics of the Railroads

The railroads furnish an outstanding example of an industry which tends naturally to become a monopoly. That is, the railroad industry is one in which free competition is wasteful, if not actually ruinous, and in which maximum efficiency and lowest costs of production can be obtained only when competition is eliminated or at least greatly restricted.

Increasing Returns in Railroading.—One of the characteristics of railroads upon which the tendency to monopoly depends is what is usually called increasing returns. A railroad is a business that requires a heavy original investment. The interest upon borrowed capital, together with other fixed charges such as the rentals of leased lines, taxes, and amounts to be set aside for sinking funds to provide for maturing obligations, make up an important part of total costs of transportation, and a part which remains the same whether the railroad runs at full capacity or at only part

[1] *Statistical Abstract of the United States, 1937,* pp. 370-390, and *Railway Age,* January 1, 1938.

capacity. As the traffic handled by a railroad increases, the operating costs increase, of course, but total costs do not increase in proportion to the increase in traffic, because of the large element of fixed costs. It follows, then, that as a railroad comes to be operated at full capacity, instead of at half capacity, the business that is handled doubles but the costs of transportation do not double, and, if the rates charged are assumed to be relatively constant, net earnings of the railroad increase.

There is nothing mysterious about the tendency described in the preceding paragraph, nor is the tendency peculiar to the railroad industry. Any industry which has a considerable amount of plant and equipment will find that it is more economical to run at or near full capacity, rather than at some lower level. Nor should one be led to jump to the conclusion that the railroad is necessarily one of those industries which are characterized by economists as "industries of decreasing costs." The concept of decreasing costs, as usually described in connection with price determination in the long run, is concerned with the average cost per unit of product which the industry would experience as it adjusted itself to different volumes of production *through changing the amount of plant and equipment* and other productive factors devoted to production. Thus, an industry which would have a lower average cost of production per unit when its productive capacity and amount of plant and equipment used were large than when capacity and amount of plant and equipment were small, is to be described as an industry of decreasing costs. But, at either a large or a small volume of production and amount of plant and equipment, any concern in the industry would find it more profitable to run at full than at part capacity, and would experience increasing returns in the sense that a railroad may experience them. The concept of decreasing costs, therefore, refers to the experience of an industry as a whole as it changes its productive capacity, while the concept of increasing returns as applied to the railroads refers to the experience of one concern in an industry as it more or less completely utilizes a given amount of productive equipment. It may be that the railroad fits into both classes, but the one does not follow from the other.

However, the tendency to increasing returns, as described above, is of particular importance in railroading, because it is more pronounced in the railroad business than in most other lines of production. As a result of this tendency, any gain in the volume

of business handled is welcomed by a railroad, while any loss of traffic is a serious matter, and consequently, under a system of competitive rates, a wild struggle for traffic usually ensues.

Joint Costs in Railroading.—A second important characteristic of the railroad business is that it operates under conditions akin to those of "joint costs." A railroad, of course, ordinarily furnishes only a single service, transportation; but a given train often carries a wide variety of articles—some of high and others of low value; some in carload lots, others in less than carload lots; some for long distances and others for short distances. The result is that the exact cost of a given unit of transportation cannot be discovered. What part of the total cost of operating a train for an 800-mile run, for example, should be charged to a ton of coal which is being carried for 63 miles in conjunction with 80 or 90 cars full of other commodities, of different values per pound, being carried for different distances, in lots of different sizes? It follows, then, that the rates charged by railroads for their services in connection with any particular lot of goods must be more or less arbitrary, being based upon a notion as to "what the traffic will bear" rather than upon actual unit cost of production of the service.

We have already shown that the tendency to increasing returns in railroading appears most clearly when a larger volume of traffic than formerly handled is carried at approximately constant rates. Under conditions of competition, however, it does not take a railroad long to discover that it will be wise, at least from the short-run point of view, to add to its volume of traffic even if it has to reduce rates to attract the new business. As long as any new traffic will bring in enough revenue to cover the special costs of handling it, and in addition contribute something toward the costs which would persist whether or not the new business is taken on, it is profitable for a railroad to go after new traffic. Unfortunately, however, rate-cutting does not usually stop with the first cut. Unless the road with the increasing traffic has really attracted some business which would not otherwise have been carried, it has increased its own traffic at the expense of some other railroad or railroads, and one cut in rates usually leads to another, until business is being carried at rates insufficient to cover even the operating costs, not to mention the fixed costs. This process of competitive rate-cutting has often been described as "cutthroat competition."

The Development of Railroad Regulation

The American Railroad Industry Under Competition.—In spite of the fact that the railroad industry is one in which competition tends to be wasteful, the construction and operation of railroads in this country went on under conditions of practically unrestricted competition for more than fifty years. Railroads were built far in advance of the needs of the territories to be served by them, and the pressure upon the railroads, with their large unused capacities, to go out and get business, at whatever cost, was irresistible. The result was severe and destructive competition, and rate wars were of frequent occurrence. In addition, certain other pernicious practices, such as local and personal discriminations, sprang up.

Local Discrimination.—The most important type of local discrimination was that in which a given shipment of goods would be carried a long distance at a lower rate than that charged for carrying it a shorter distance. For example, as between New York City and Chicago, a low rate on a given commodity would be likely to prevail because of competition among several railroads operating between these two great terminals, while a railroad would charge a higher rate on this same good as between New York and some intermediate point at which competition with other railroads did not exist. Sometimes the rate charged to the intermediate point was the sum of the through rate from New York to Chicago and the local rate from Chicago back to the intermediate point. So long as the through or competitive business paid for the special costs of handling it, and contributed something to the other transportation costs, it was profitable for the railroad to take it. Moreover, the rates to the local or intermediate points would not usually have been lowered if the railroad had given up the competitive business, for the local traffic would then have had to bear both the operating costs and the fixed costs in their entirety, whereas the through or competitive traffic contributed something toward the fixed costs.

Personal Discrimination.—The pressure to get business, when railroads had unused capacities, manifested itself also in personal discrimination, which means charging one person more than another for substantially the same service, or giving one person more service than another while charging the two the same rate. Favors of this sort were granted by means of a great many devices which

are too numerous to note here, and were accorded chiefly to the more powerful shippers, that is, to those who had the largest quantities of commodities to be transported. The effect of widespread personal discrimination is to reduce the railroads from the status of common carriers to that of contract carriers, or carriers which undertake each particular bit of transportation service on the basis of a separate agreement as to service and rate.

Attempts to Restrain Competition.—Groups of railroads in different parts of the country at times became mindful of the ruinous nature of competition, and entered into agreements among themselves with the intent of restricting competitive activity. At times the subject of the agreements was rates, and the railroads would promise to maintain a given rate structure for a certain period of time. At other times, pooling agreements were entered into, and the railroads undertook to pool their traffic or the earnings from traffic, and to divide the business or the profits from it according to some prearranged ratio. While agreements of this sort were not punishable by law prior to 1887, they were nevertheless unenforceable at law, and there was every incentive for the railroads to attempt at times to evade the provisions of the agreements. As a result, most of these agreements did not enjoy long life.

Early Railroad Regulation.—The disastrous effect of competition on the railroads, the complaints of shippers concerning local and personal discrimination, the fear of monopoly power under rate and traffic agreements, the speculation and fraud which pervaded railroad finance, and the attitude of railroad officials and executives toward the public, were some of the causes which influenced Congress to begin a long career of railroad regulation by passing, in 1887, the Act to Regulate Commerce. The legislation pertaining to the railroads has been constantly changing since that time, but it was only after almost thirty-five years of regulation that anything like a constructive approach to the railroad problem was adopted in our railroad legislation. It will be impossible in this chapter to analyze in any detail the provisions of the various Acts which have been passed in regulating the railroads, but it is essential to an understanding of the railroad problem of today that the chief defects of the early railroad legislation should be pointed out. The two principal defects were closely related to each other.

The Negative Character of Early Legislation.—One defect of our regulatory scheme prior to the last twenty years was that it concerned itself chiefly with provisions intended to keep the railroads within bounds, and to prevent the exploitation of the public through unreasonable transportation charges and arbitrary maladjustments in rate relationships. The principal aim of regulation was to wipe out railroad abuses, and consequently most of the provisions of the legislation took the form of prohibitions. For example, the railroads were warned that they must not discriminate between persons or companies, must not charge more for a short haul than a long haul unless granted specific permission, and must not enter into agreements for the pooling of traffic or earnings. From a positive point of view, not much was said as to what the rates should be. Our legislation did provide, of course, that rates should be "just and reasonable," but no significant meaning was given to these terms prior to the legislation passed in 1920. In short, the early railroad legislation treated in detail the things that the railroads should not do, but paid little or no attention to what they should do if the country was to have an efficient national transportation system. The items which were omitted from the regulation, rather than those which were included, seem to us to constitute the primary purpose of regulation.

The Policy of Enforced Competition.—Though attempts were made, as was stated above, to eliminate some of the worst abuses which sprang up under competition, there was a continued insistence on competition as the condition under which the development of our railroad system should go on. "The anti-pooling clause of the Act to Regulate Commerce, and the prohibitions of the anti-trust laws as judicially applied to the railroads, created serious practical obstacles to the development of responsible relations between the carriers, to the elimination of personal preferences, to the stabilization of competitive conditions, to the achievement of such economies as coordination might render possible, and to the full and flexible utilization of the available plant and equipment. This condemnation of cooperative effort among the carriers through insistence upon the rigorous enforcement of competition, despite the subversive tendencies of such competition in the direction of rate fluctuations and discriminatory practices, and despite the difficulties of maintaining uniform charges among competitors of strikingly unequal strength, was but a reflection of the primary emphasis of the regulatory scheme upon restraining the potential

overreaching of quasi-monopolistic power rather than upon the provision of a satisfactory system of transportation."[2]

The Railroads and the World War.—Because of the nature of our railroad legislation, its application brought results which were, in many respects, undesirable. We spent too much time seeing to it that railroad rates were not unreasonable or discriminatory, and gave too little attention to the question of efficient railroad transportation and to providing the railroads with a rate system which would permit them to earn a sufficient amount to enable them to attract into the industry the capital so necessary for continued efficient operation. Consequently, when the heavy traffic of the World War period began to make unparalleled demands upon our railroads, they were unable to respond adequately. During this great national emergency, the wastefulness of competition in railroading and the importance of having an efficient national system of transportation were fully realized for the first time.

In order to avoid the complete breakdown of our system of railroad transportation which seemed imminent, the federal government undertook to operate the railroads during the participation of the United States in the World War, and for some time afterward. It was impossible, of course, to revolutionize the railroad industry and transform it instantly from a disorganized and inadequate competitive system into an efficient national organization, but many steps were taken during the period of federal operation which augured well for the future. The railroads were operated "as a national system of transportation, the common and national needs being in all instances held paramount to any actual or supposed corporate advantage."[3] Locomotives and other rolling stock were pooled and used as necessity dictated, without regard to ownership. Shipments of freight were moved to their destinations by the most direct routes regardless of the wishes of shippers as to routes or the amount of use made of any particular railroad in the process. Certain railroads were compelled to share their terminals with other railroads, and repair shops were used jointly. Cars were loaded heavily and the demurrage rates, or charges for leaving freight in the railroad cars in excess of a reasonable length of time, were increased to speed up car-unloadings. Passenger service was cut down, and consolidated ticket offices were intro-

[2] I. L. Sharfman, *The Interstate Commerce Commission,* New York, Commonwealth Fund, 1931, part I, pp. 79, 80.

[3] *Ibid.,* p. 155.

duced. The purchase of materials and supplies was centralized, new equipment was standardized, expenses for advertising were reduced, and valuable uniform statistics were compiled.

Whatever conclusion may be reached as to the financial or operating success of the federal control of the railroads, we may at least be thankful for the new attitude toward the railroads which prevailed after the war. When the question of the terms upon which the railroads should be turned back to their private owners was being considered, many different plans were evolved, and yet they all agreed more or less completely in one particular. This was that the growing transportation needs of the country demanded, through some method or other, the welding together of the many independent railroads, each formerly following its own self-interest, into an efficient national system of transportation. It appeared that only by some plan of consolidation or cooperation could economies in operation be achieved, and the railroad plant and equipment be efficiently utilized, while difficulties of rate regulation were being overcome.

The Transportation Act of 1920

The attitude toward the railroads described above received its first legislative expression in the Transportation Act of 1920. Under this legislation, the control of the railroads subject to the provisions of law was continued in the hands of the Interstate Commerce Commission, the agency set up for that purpose in 1887 by the Act to Regulate Commerce. The Interstate Commerce Commission is made up of nine members, appointed for terms of seven years each by the President of the United States with the consent of the Senate. The work of the Commission is expedited by the provision that it may organize itself into as many divisions, of not fewer than three members each, as may be necessary to handle its business, and that each division may act independently of the others, with its decisions subject to reconsideration by the Commission as a whole. The Act of 1920 placed upon the Interstate Commerce Commission some new responsibilities which were expected to be of great import in connection with the solution of the railroad problem. We shall consider the provisions of the law and their operation under four headings—railroad consolidation, rates, securities, and service.

Railroad Consolidation.—In the first place, the Act of 1920 was noteworthy in that the traditional emphasis on competition

in the railroad industry was discontinued. The Interstate Commerce Commission was ordered to prepare and adopt a plan for the consolidation of the many railroads of the United States into a limited number of systems. In drawing up such a plan, the Commission was asked to bear two considerations in mind: (1) To preserve as far as possible the existing conditions and channels of trade, and (2) to make each system such a combination of weak and strong roads that, when uniform rates are applied throughout the country, each system will make substantially the same rate of return upon the value of its property devoted to the transportation service as that made by the other railroad systems. Under the consolidation plan (whenever formulated by the Commission), it was made lawful for two or more railroads to consolidate their properties for ownership, management, and operation, subject to two conditions: (1) The Commission must approve the proposed consolidation as being in line with its final consolidation plan, and (2) the par value of the bonds and stocks of the new consolidation must not exceed the value of the consolidated properties as determined by the Commission.

As a temporary expedient, pending the adoption of the final consolidation plan, it was provided that the Commission could permit one railroad to acquire control of another railroad or other railroads, by means of leases, stock purchases, or any method not involving actual consolidation. In addition, while agreements for the pooling of freight or net earnings were still held to be unlawful in and of themselves, it was provided as another temporary expedient that the Interstate Commerce Commission could approve such agreements and render them valid, or even go to the length of taking the initiative in bring them about.

The Benefits of Consolidation.—The benefits, from a social or national point of view, which might be expected to result from the consolidation of the railroads of the country into a limited number of systems as provided in the Act of 1920, are familiar ones. First, they would make it possible to realize important economies in operation and to utilize to the maximum the existing plant and equipment of the railroads, by methods similar to those employed by the federal government during its operation of the roads. These methods would include, of course, the pooling of locomotives and cars and their use anywhere in the system, the joint use of terminals and other facilities, heavy loading of cars, centralized purchases, standardized equipment, and uniform statis-

tics. In the second place, the consolidation plan would replace numerous existing lines, of varying financial condition and command over traffic, with a small number of systems of approximately equal strength. As a result, rate regulation would be facilitated.

Rate Provisions of the Act of 1920.—Congress, in drawing up the Transportation Act of 1920, was mindful of the necessity for adequate earnings in railroading and tried to make provision in the Act for rates which would make such earnings possible. The Commission was given the power to establish both maximum and minimum rates and, by fixing both, to decide upon the actual rates. Furthermore, it was made the duty of the Commission to exercise its rate-making powers in such a way that the railroads as a whole, or as a whole in such rate groups or territories as it might designate, would earn an aggregate annual net railway operating income equal, or as nearly equal as might be, to a fair return upon the aggregate value of the property of such railroads used in the transportation service. The valuation of the railroad property and the determination of what constituted a "fair rate of return" upon such property, were to be in the hands of the Commission. In determining such fair rate of return, the Commission was to bear in mind the transportation needs of the country and the necessity of expanding railroad facilities, if adequate transportation was to be furnished. It will be noted that no provision whatsoever was made for individual railroads to earn a fair rate of return. It was only for the railroads as a whole, or in certain groups as designated by the Commission, that fair returns were to be sought The word "group" in this connection may, we believe, be taken to mean a group of railroads somewhat larger than one of the limited number of systems into which the railroads of the country were to be consolidated.

The Recapture Clause.—It was realized, of course, that rates high enough to give a fair rate of return for the railroads as a whole or in large groups would furnish some strong roads enjoying good location and excellent physical condition the chance to make an excessive rate of return. The "recapture clause" in the Act of 1920 was intended to provide against this contingency. According to the provisions of this clause, any railroad which received in any year a net railway operating income of more than 6 per cent on the value of its property devoted to transportation was required to share the excess above 6 per cent with

the government. One-half of the excess income was to be turned over to the Commission for the purpose of setting up what was called a "general railroad contingent fund," while the other half was to be held in a reserve fund by the railroad. When the amount in this reserve fund equaled 5 per cent of the value of the railroad's property, the fund could be drawn upon only to meet fixed charges and make dividend payments in years when its net operating income fell short of the 6-per-cent level prescribed by law. The general railroad contingent fund, on the other hand, was to be used by the Commission to make loans at 6 per cent interest to needy railroads, for the purpose of developing equipment or refunding maturing obligations, or to buy railroad equipment and lease it to the railroads.

Railroad Securities Under the Transportation Act of 1920.—A third division of the Act of 1920 concerned itself with the control of railroad securities. The principal purpose of such control was to make sure that the financial operations of the railroads in the future would be of such a nature as to provide a sound basis for the rehabilitation of railroad credit and for the development of the railroad system. In addition, it was desired to protect the investing public against loss through extravagant and even dishonest financing, such as had taken place at times in the past. The principal provision of the Act, with respect to securities, was to make it unlawful for railroads to issue their own securities or to assume any obligations in connection with the securities of other railroads unless, after their application to the Commission and after investigation by the Commission of the purposes and uses of the proposed financial operation, the Commission should give its consent. The Commission was given rather wide discretionary power in deciding these financial matters, but it was asked to bear two considerations in mind: (1) The proposed transaction must be for some lawful purpose within the business of the railroad, and (2) it must be reasonably necessary and appropriate for this purpose.

Service Regulation.—The fourth major problem touched upon by the Act of 1920 was that of adequate railroad service. Each railroad was ordered to furnish safe and adequate car service, and to set up and enforce reasonable rules and practices with regard to such service. Car service was taken to include the supply and use of rolling stock, the supply of trains, and interrailroad relationships with regard to rolling stock. The Commission was

also empowered, when it considered such action desirable, to formulate reasonable rules and regulations to govern the railroad car service. In case of emergency, the Commission could abolish all existing regulations with regard to car service, and proceed (without regard to the desires of any particular railroads) to provide for the unified utilization of railroad facilities, for the joint use of terminals, for preference or priority for certain commodities in transportation, and for direct routing and expeditious handling of traffic.

Finally, the approval of the Commission had to be obtained before an existing railroad enterprise, or any part of it, could be abandoned, or any new construction of railroads undertaken. Furthermore, in this connection, the Commission was again given power to take the initiative, and order a railroad to provide itself with safe and adequate facilities for carrying on its car service, or to extend its lines by means of new construction.

The Railroads in the Great Depression

Progress Toward Consolidation.—Though the Transportation Act of 1920 represented a refreshing and desirable change of attitude toward the railroad problem, it did not furnish a satisfactory basis for the operation of the railroads in the years after its passage. In the first place, comparatively little progress has been made toward the consolidation of the railroads. It is true, of course, that the Commission in 1921 published a tentative plan which provided for the consolidation of the railroads of the country into nineteen systems. One system was to provide for the needs of New England, five were to be trunk-line systems between New York and Chicago, and five were to be transcontinental systems from Chicago to the Pacific coast. The lower Michigan peninsula was to have one system, and there were to be two "soft coal" lines from the Chesapeake Bay to the Great Lakes. Finally, there were to be three systems in the Southeast and two in the Southwest. Extended hearings were conducted to consider the plan, but little has been done toward putting it into operation. However, several railroads have been allowed to carry out plans for consolidation with other roads or for the acquisition of control over them as provided in the law.

It must be remembered that consolidation is to be voluntary on the part of the railroads, and cannot be forced upon them by the Commission under the present law. Consequently, there are

some reasons for thinking that consolidation will not go forward at a very rapid pace. In the first place, the strong railroads, which are in good physical condition and have undoubted earning power, may not be willing to join forces with the weaker roads to form the systems called for by the consolidation plan, or at least would agree to go into such consolidations only upon terms rather unfavorable to the weak roads. In addition, the railroad officials who would naturally carry on the negotiations for consolidation may not be anxious to do so because of a fear that in the new system they might be forced to accept positions inferior to those which they now hold.

The Control of Railroad Securities and Service.—The provisions of the Transportation Act relative to railroad securities and service have not been of great practical importance up to the present time. Since 1920, and especially since 1929, railroad earnings have been so low that railroad credit has not rated so high as in former times. The carriers have consequently experienced considerable difficulty in refunding their maturing obligations on satisfactory terms, and new issues, for many roads, have been practically out of the question. The control of railroad service by the Commission has been a source of irritation to railroad executives. They complain of the situation as one in which a company cannot extend its facilities if business is profitable, or abandon production if business results in large net losses, without the approval of a governmental commission, and in which a company may be asked to share its productive facilities with competing companies. However, it is doubtful that the Commission's control over railroad service has ever been genuinely effective.

Railroad Earnings Since 1920.—The most serious criticism of the Transportation Act of 1920 is that under its operation railroad earnings were never satisfactory and sank to a very low level after 1929. Apparently many people thought that the Act had disposed of the problem of adequate railroad earnings for some years to come, but a study of the net operating income of the railroads since 1920 discloses that such was decidedly not the case. The rate of net operating income of the Class I railroads in the United States, based upon the aggregate value of their property devoted to the transportation service from 1921 to 1938, is shown in Table 26. It should be noted that the percentages there presented are for the Class I railroads as a whole, and that they are calculated upon the valuations which the railroads

TABLE 26.—THE RATE OF RETURN EARNED BY CLASS I RAILROADS, AS A WHOLE, UPON THE AGGREGATE VALUE OF THEIR PROPERTY DEVOTED TO THE TRANSPORTATION SERVICE, 1921–1938[a]

1921	2.87%	1930	3.30%
1922	3 59%	1931	2.00%
1923	4 33%	1932	1 25%
1924	4.23%	1933	1 83%
1925	4.74%	1934	1.79%
1926	4 99%	1935	1.93%
1927	4.30%	1936	2.59%
1928	4.65%	1937	2.30%
1929	4.84%	1938 (11 months)	1 34%

[a] Sources: *Statistics of Railways of Class I, 1935*, Washington, Bureau of Railway Economics, 1935; *Statistical Abstract of the United States, 1937*, pp. 370–390, *Chicago Tribune*, December 15, 1938.

themselves put upon their properties. If calculated on the basis of the Commission's valuations of the railroad properties they would be slightly higher, because the latter valuations have ordinarily been somewhat more conservative than those of the railroads themselves.

While it is difficult to say just what rate of return upon the aggregate value of railroad properties would be adequate, and no more than adequate, for the maintenance of an efficient transportation system, we may at least point out that the rates actually earned by the railroads since 1920 have been consistently below the rate determined upon by the Commission as one which it considered adequate and reasonable. The Commission decided in 1922 that, for the railroads as a whole, a rate of 5¾ per cent upon the aggregate value of the railroad properties used in the transportation service would be adequate; and it will be remembered that under the Act of 1920 the "recapture" of the earnings of individual railroads was to begin at 6 per cent. If the Commission's figure of 5¾ per cent is accepted as satisfactory for the railroads of the country as a whole, it is clear that the railroads, even in the relatively good period of business between 1921 and 1929, did not earn an adequate rate of return in any year.

Railroad Finances in the Depression.—In the post-1929 depression, with its sharp decline in the volume of goods requiring transportation by any agency, the railroads were very hard hit. The net earnings of Class I railroads fell from 4.84 per cent on the aggregate value of their property in 1929 to the ridiculously low figure of 1.25 per cent in 1932, had risen by 1936 to 2.59 per cent, but suffered a fresh decline in 1937 and 1938. It should

be noted, moreover, that these figures are for net operating income *before the payment of interest charges.* After paying interest charges, the Class I railroads had net deficits in nearly all recent years.

The number of passengers carried by these roads, which had averaged 1,114,055,000 annually from 1916 to 1920, declined to 432,980,000 in 1933, while the revenue freight carried, which had averaged some 427,234,000,000 ton-miles from 1926 to 1930, fell to 233,977,000,000 ton-miles in 1932.[4] Railroads have failed in large numbers in recent years. By the end of 1937, ninety-six railroads, with 71,386 miles of line, had gone into bankruptcy, and were operating under the supervision of the courts. Heavier casualties would probably have occurred had it not been for the activities of the Reconstruction Finance Corporation and the Public Works Administration, in lending some $738,101,000 to the roads. Of this sum, $224,839,000 had been repaid by the end of 1937.[5]

The Causes of the Railroad Problem

The Attitude of Railroad Officials.—While the desperate situation of the railroads in recent years is largely chargeable to the depression, several factors operated to put the industry in a vulnerable position. One was the attitude of railroad officials toward their own business and other forms of transportation. Some years ago, when the railroads provided the only satisfactory means of long-distance transportation, they could count upon carrying most of the passenger and freight traffic of the country. In other words, the demand for their service was inelastic. Under this condition of demand, high rates for passenger and freight tended to yield better financial returns than low rates, and a rate increase could usually be depended upon to increase railroad earnings, if additional income was necessary.

But in recent years motor vehicles, and to some extent the airplane, have developed into efficient and satisfactory agencies of transportation. Consequently, the country is no longer absolutely dependent upon the railroads, and can take their service or leave it, depending upon the comparative rates and service of the railroads and other transportation agencies. Hence, the demand for railroad service is now relatively elastic. Under this

[4] *Statistical Abstract of the United States, 1935*, pp. 368-375.
[5] *Railway Age*, January 1, 1938

condition of demand, high rates may prove financially disastrous to the railroads, while low rates may bring increased business and improved net earnings.

It would seem that many railroad executives failed to recognize the changes that had taken place in transportation, and continued to think of the service provided by railroads as absolutely essential. In 1931, when railroad traffic and earnings were declining rapidly, the railroads petitioned the Interstate Commerce Commission for increases in freight rates to bolster up their declining earnings. After much discussion and argument, the roads were granted conditional increases in the rates applying to specified commodities, though a change in the opposite direction would probably have had a more salutary effect. Similarly, in 1936, many of the eastern railroads vigorously opposed the decision of the Commission to reduce railroad passenger fares in the hope of increasing traffic and earnings. The conservatism of railroad officials also manifested itself in their reluctance to adopt improvements in railroad equipment and service. Here, again, they acted as though they regarded the demand for railway services as inelastic, instead of elastic as it now is because of the existence of satisfactory substitutes.

The Railroad Labor Situation.—Another factor operating to accentuate the railroad problem was the favorable treatment which the railroads were required by law to afford the workers in the industry. The federal government, in carrying out its policy of railroad regulation, has not hesitated to raise the status of labor in the industry. Railroad gross earnings in 1937 were only slightly greater than in 1916, but railroad wages were much higher. In 1916, the average railroad employee worked 3149 hours for an income of $886, or 27.5 cents an hour. In 1937, the average employee worked 2499 hours for $1764, or 70.6 cents an hour. Hence, the average employee worked 20 per cent less time in 1937 than in 1916, but received wages amounting to 99 per cent more. The total wage bill of the railroads was 31 per cent greater in 1937 than in 1916, while the number of employees was about 34 per cent smaller.[6]

The railroads are compelled by law to maintain safety appliances for the protection of their workers, and the employees, of course, receive free transportation from the roads for which

[6] *Railway Age,* January 1, 1938, and *Statistical Abstract of the United States, 1937,* pp. 370-390.

they work. Bills have been introduced into Congress providing the future payment of the same wages for six hours' work a day as are now being paid for eight hours, and for a dismissal compensation for employees affected by abandonments or unifications of railroads. While these advantages may not be greater than the railway employees should enjoy, they have unquestionably constituted a heavy burden upon the industry in times of depression. On this account, a general 10 per cent reduction in railway wages was permitted, and became effective on February 1, 1932. However, the 1931 level of wages was completely restored by April 1, 1936.

A Defect in Rate Regulation.—It appears to many that the principle of rate regulation set up in the Transportation Act of 1920 was defective in that it provided for the recapture of so-called excess earnings of the individual railroads. If the railroads of the United States are to make a fair rate of return (say, 5¾ per cent) on the aggregate value of their property over a period of years, it will be necessary for them to make much more than that rate in some years, since they certainly will make much less than a fair rate of return in others. It was possible, of course, for individual railroads to obtain a higher rate than 5¾ per cent in certain years, by sharing the return in excess of 6 per cent with the government; but the rates which the railroads as a whole could charge for their services appeared to be adjusted in such a way that no more than the prescribed fair return would be earned by them as a whole in any year, while in some years the rate of return was certain to be less than that established by the Commission. If the 5¾ per cent rate of return is to be significant, it must be interpreted as a long-run rate, that is, one which will tend to be realized over a period of years; and under this interpretation the railroad charges for freight and passenger service and other conditions of transportation should be regulated by the Commission, so that more than 5¾ per cent may be earned in good years to offset the smaller returns of bad years. Otherwise, railroad credit and even the physical condition of the railroads seem certain to be further impaired.

Competition in Transportation.—Probably the principal factor giving rise to the railroad problem was the loss of passenger and freight traffic to automobile and water carriers, both before and during the post-1929 depression. After many years and much legislation of the trial and error variety, we eventually arrived

at the significant conclusion that consolidation and cooperation of railroad lines are preferable to their competition as a means of effecting efficiency and economy in railroading. However, we have been slow to realize that it is equally likely that coordination and cooperation of the several types of carriers—rail, water, motor, and air—would be better than competition, from the point of view of developing an adequate and efficient national system of transportation.

Of course, not all of the railroad traffic losses were due to the competition of other types of carriers. Moreover, the railroads have no legitimate grievance in connection with the loss of traffic to other types of carriers, so long as the traffic gains of these carriers are based on superior service, more efficient operation, and lower costs. But the railroads have often charged that traffic has been taken from them by unfair competition. Into this question, we must look a little further.

Water Competition.—There can be no doubt that there is a place for water carriers in our transportation system, but the railroads have complained that much of the traffic handled by water carriers was secured on the basis of costs that were low only because of special advantages and favored treatment received by these carriers—treatment not accorded the railroads. In other words, it is contended that the competition furnished by some water carriers is essentially unfair to the railroads.

Certain inland waterways have been constructed at heavy cost to the federal government, and have proceeded to charge shippers rates so low that the receipts would barely cover the operating expenses of these water lines. When this sort of thing takes place, the shippers, of course, are not paying the full costs of transportation, but are being subsidized because the taxpayers assume the expenses for fixed charges and maintenance. The railroads, on the other hand, must maintain tracks, bridges, and terminals, and pay their own fixed charges and taxes. Thus, they not only lose traffic to these waterways, but pay heavy taxes as well, part of which go to the support of the waterways, their competitors. Incidentally, the taxes paid by Class I railroads in 1937 amounted to $336,000,000, or about 57 per cent of their net operating income of $590,000,000, before paying interest charges.[7]

To take an extreme example, let us consider the Mississippi-

[7] *Railway Age,* January 1, 1938.

Warrior Rivers Barge Line. It has been estimated that some 600 million dollars were expended by the government on this system and its branches. Since its construction as a war project, this barge line had carried, up to 1929, some 7¾ million tons of freight at an average annual loss, borne by the taxpayers, of $440,000; and this figure does not include any allowance for ordinary interest, taxes, and depreciation, such as a private transportation enterprise would have to meet.[8] Not all water carriers, of course, can be compared with the Mississippi-Warrior Rivers Barge Line; but it is probable that a considerable portion of the freight carried by water lines, amounting annually to hundreds of millions of tons, is carried at rates insufficient to cover costs of production, if interest, maintenance expenses, and the taxes which would be collected from strictly private transportation agencies, were included in costs of production. This situation is clearly a cause for concern to the railroads.

Motor Competition.—The competition of carriers by motor has been an even greater thorn in the flesh than that of water carriers. Not only do large numbers of people transport themselves from place to place by automobile, but common carriers by bus have also made a hole in the passenger traffic receipts of the railroads. In addition, tremendous quantities of freight are now being carried by truck, both for short and long distances. Some of the trucks operate as common carriers, that is, they run over regular routes at certain specified times and serve all comers; while others operate as contract carriers, furnishing each bit of transportation service on the basis of a separate agreement as to conditions of transportation, including rates, between the trucking company and the customer. Finally, some companies, engaged in other lines of business, do their own trucking.

The Advantages of Motor Carriers.—Again, the railroads had no thought of contending that there is no place in our transportation system for carriers by motor, but they claimed that much of the competition furnished by these carriers was unfair to the railroads so long as the motor carriers were unregulated as to rates and other conditions of service, and enjoyed special advantages that were not available to the railroads in furnishing their transportation service. First, with regard to the alleged advantages enjoyed by motor carriers, it was pointed out that they

[8] E. E. Loomis, "Railways *vs.* Waterways," in *Review of Reviews*, February, 1929, pp. 79-82.

are largely exempt from certain types of expenses which the railroads have to bear. The roadbed for the motor carriers is the public highway, constructed and maintained at public expense, and the fixed charges on the investment in these highways are not paid by these carriers.

It was recently estimated that truck operators pay, on the average, only 3.6 per cent, and buses only 7.23 per cent of their gross earnings in taxes, which of course includes their only contribution toward the maintenance of, and fixed charges on, the investment in their roadbed, the public highways. The Class I railroads of the country in 1935 paid 6.6 per cent of their gross income for taxes alone; and if the expenses of maintaining roadways and interest on the investment in roadway were included, the percentage would be much higher. For example, it was estimated that the Reading Company found it necessary, in a given year, to pay out 26.46 per cent of its gross operating revenues for taxes, interest on investment in roadway, and maintenance of roadway.[9] Even if interest on the investment in roadway were not included, on the ground that rights-of-way, extra land, and in some cases money were given to the railroads by the various governmental units many years ago, the figure would still have been 15.46 per cent for the Reading Company. If this figure is even fairly typical of the railroads of the country as a whole, it is small wonder that carriers by motor have been able to offer services for passengers and some kinds of freight at rates well below those which the railroads have had to charge.

The Lack of Motor Carrier Regulation.—In the second place, the railroads complained that the motor carriers were almost completely unregulated. Given the advantages outlined above, these carriers were left relatively free to charge any prices they liked for their services, while the railroads could make no changes in their rates to meet motor competition. Changes in railroad rates could be made, of course, but only slowly and with the consent of the Interstate Commerce Commission, and consequently the rates could not be made flexible enough to meet the rapid changes in rates open to the unregulated motor carriers. A truck owner could take a load a certain distance at a remunerative rate and, rather than return with an empty truck, could afford to pick up a return load at almost any price obtainable. He could

[9] Agnew T. Dice, President of the Reading Company, in an address before the Atlantic States Shippers' Advisory Board, at Philadelphia, October 2, 1931.

charge Jones one rate, Brown another, and Johnson a third, for exactly the same service. He could charge more for a short than a long haul, and was subject to almost no restrictions as to adequacy or regularity of service, being permitted to enter or quit the business at will. None of these advantages have been enjoyed by the railroads. To have permitted competition between motor carriers and the railroads to continue on the terms described above would have been to sanction a condition which was fraught with danger for the railroad industry, and to make it extremely unlikely that the railroads, being closely regulated, could earn a return adequate to insure continuous, efficient transportation service.

Solving the Railroad Problem

The Federal Railroad Coordinator.—As a result of the depression and the other factors affecting the railroad problem, the railroad industry was in a woeful condition when the Roosevelt administration took office in March, 1933. This administration, however, lost no time in trying to assist the railroads. It was thought that part of the railroads' difficulty in obtaining adequate revenue was due to their failure to effect the economies which had been expected to accompany consolidation. As we have seen, consolidation had moved at a snail's pace since 1920, and the independent railroads did not cooperate in such a way as to reap any considerable part of the benefits which were expected to result from consolidation. Therefore, in 1933, a law was passed creating the office of Federal Coordinator of Railroads, which office was filled by Joseph B. Eastman, former member of the Interstate Commerce Commission. The duties of the Coordinator were (1) to encourage and promote, or require, the elimination of unnecessary duplication and waste, and (2) to recommend further legislation for the improvement of transportation conditions. Though the Coordinator was continued in office until 1936, his work was hampered by the hostility of the railroad executives.

The Motor Carrier Act.—Another accomplishment of recent years was the passage in 1935 of an Act to regulate motor carriers. The Act was to go into effect on October 1, 1935, but the operation of any part of it could be postponed by the Interstate Commerce Commission, and so the Act did not actually become operative until several months of 1936 had elapsed. While this legislation was not intended primarily to protect other forms of transportation, but rather to improve and stabilize conditions in

the motor carrier industry itself, the competition of motor carriers has affected the railroads so seriously in the past that we may well consider briefly the provisions of the Motor Carrier Act.

Provisions of the Act.—The law applies to common carriers, contract carriers, and brokers, engaged in interstate commerce by motor vehicles, but not to private carriers, except possibly with respect to safety regulations. The Act gives the Interstate Commerce Commission authority to prescribe rules governing employees, hours of service, and standards of equipment in the motor carrier industry. The numerous exceptions to the application of the law include school buses; taxis; hotel buses; motor vehicles operated by the Department of the Interior in the National Park service; motor vehicles used by farmers; motor vehicles of cooperative agricultural associations; trolley buses operated by electric power; motor vehicles carrying livestock, fish, and agricultural commodities exclusively; motor vehicles carrying newspapers exclusively; transportation within municipalities and adjacent areas; and casual, occasional or reciprocal transportation by a person not engaged in transportation as a business.

Common carriers must secure certificates of public convenience and necessity, and must show the need for their service and their willingness and ability to perform it. Their business may include movements between fixed terminals and over regular routes, and only such business, but equipment and facilities may be added freely. Contract carriers must secure permits to operate, and must show the need for their service, their ability to perform it, the nature of the goods to be transported, and the territory to be served. They do not operate between fixed terminals, or over regular routes. Brokers, or persons other than carriers and their agents who sell transportation which is subject to the Act, must secure licenses, and show the need for their service and their ability to perform it. Common carriers already in operation on June 1, 1935, contract carriers in operation on July 1, and brokers in business on October 1, were allowed to secure certificates, permits, or licenses without further proof by making proper application before the last available date as fixed by the Commission.

Common carriers must file rates and abide by them, subject to heavy fines for transporting without filing rates or for charging rates other than those on file. The rates must be reasonable and non-discriminatory, and may be changed only upon thirty days' notice to the Commission and the public. Contract carriers need

filė and publish only minimum rates. They may charge more than these rates, but changes in the minimum rates require thirty days' notice. The Commission does not have authority to prescribe the original rates for the motor carriers, but upon complaint or on its own initiative it may suspend and investigate any rates except the original ones. It may investigate the lawfulness of the rates on file and if, after holding hearings, it finds that rates do not comply with the law, it may prescribe new rates.

For purposes of enforcement, a division of four members of the Commission was created to supervise all matters pertaining to motor vehicles. Under this division, a motor carrier bureau was established with district offices in various parts of the country. Violations of the law are subject to a $500 fine for a first offense, and $2000 fine for each additional offense. These penalties apply to both shippers and carriers. The common carriers must give bills of lading for goods transported, and the carrier which first handles a shipment is responsible to the shipper for any loss, damage, or injury caused by it or any other carrier, but the first carrier has a claim upon a subsequent carrier if the fault lies with the latter. The Commission controls security issues, consolidations, mergers, and acquisitions of control in the industry, and may recommend additional legislation. It is also authorized to investigate and report on the need for regulations as to the size and weight of motor vehicles.

A Preliminary Estimate of the Law.—It is too soon as yet to pass judgment upon this attempt to regulate motor transportation. At the very outset of the operation of the law there was considerable confusion. Motor carriers filed tariffs, and then requested immediate changes. In some cases they failed to collect the published rates and fares, and did not make their tariffs available for public inspection. Sometimes the rates announced by carriers differed considerably from those announced by their authorized agents, and the carriers complained grievously about one another. It is clear that there are considerable practical difficulties to be overcome in enforcing this law, because there are so many operators and because the business of many motor carriers is by no means so regular, well established, and easy to supervise as that of the railroads. If shippers cooperate whole-heartedly with the Commission, and if appropriate penalties are imposed upon violating shippers and carriers, the law may operate successfully. If the Act can be administered with reasonable efficiency, it will go

far toward stabilizing conditions in the motor transportation industry, eliminating cutthroat competition between motor carriers and railroads, and laying the foundation for the sound future development and coordination of these two branches of transportation.

The Recapture Clause.—In 1933, the recapture provision of the Transportation Act of 1920 was repealed. This clause, it will be remembered, required individual railroads to turn over to the government one-half of their net operating income in excess of 6 per cent, on the value of their properties devoted to transportation, and to place the remainder of such excess earnings in a reserve fund. The recapture clause had been a source of great annoyance to the railroads, though it probably was not a serious financial burden in view of the generally low railroad earnings since 1920. The clause seems to be inconsistent with the declared principle of allowing the railroads to earn a fair return upon a fair valuation of their transportation properties, and we believe its repeal should be permanent.

Improvements in Railroading.—In the past few years, the railroads have manifested a startlingly progressive attitude toward their business. Some have adopted streamline trains for certain routes, and these trains are said to have both increased the speed and convenience of the service and lowered the operating costs. Many roads have installed air-conditioned passenger cars, and made other changes in equipment which have increased the comfort and convenience of railroad travel. Many have also inaugurated what is called a store-door pick-up and delivery service, to make the railroad freight service comparable to that furnished by motor carriers, and have in some cases begun to operate their own trucks and buses. Such a wide-awake attitude on the part of the railroads is likely to be much more conducive to a solution of their problem than their former "standpat" attitude.

Passenger Rates.—The Interstate Commerce Commission, through its control of both maximum and minimum railway rates, holds the power to decide what passenger and freight charges are to prevail. In 1936, the Commission decided to investigate the effects of reduced passenger rates. It ruled that the basic passenger fare should be changed from 3.6 cents to 2 cents a mile in coaches, and to 3 cents in Pullman cars; and also eliminated the 50-per-cent surcharge on Pullman service. It was hoped that these reductions would bring an increase in passenger traffic which would more

than offset the lower fares, and thus yield the roads a greater net income from passenger traffic. The results of this experiment cannot be stated with definiteness. Railroad passenger traffic picked up sharply under the low rates, but before the full effects of the reduced charges could be thoroughly tested, the business recession of 1937-38 brought an upset to all calculations. In July, 1938, the Interstate Commerce Commission permitted the railroads east of Chicago to raise the basic passenger fare from 2 to 2½ cents a mile, and these roads promptly made the change. This ruling of the Commission would seem to suggest that the rate reduction of 1936, though sound in principle, may have been too great in size.

Freight Rates.—With earnings in the early part of 1938 running far below those of the previous year, the railroads appealed to the Interstate Commerce Commission for a 15-per-cent increase in freight rates. In March, 1938, the Commission granted what was called a 10-per-cent increase, but there were so many exceptions that the increase amounted to only about 5 per cent throughout the entire rate structure. The roads are expected to derive about $270,000,000 in additional revenue through this increase, but the actual effects are a matter which the future must decide. The railroads may lose so much traffic to other agencies of transportation that this loss will more than offset the increase in rates. The railroads contend that the extra revenue, if actually realized, will merely cover recent increases in costs of production, and will not in reality better their financial condition. Later in 1938, the roads requested a further "emergency" increase of 5 per cent in freight rates.

Railroad Wages.—In May, 1938, the railroads decided to reduce the wages of their employees by 15 per cent, effective July 1, 1938, but later changed this date to December 1, 1938. Declining revenues and increased expenses of operation had combined to make the railroad situation even more serious than in 1932, and the roads determined upon a wage cut in the hope of saving some $250,000,000 annually. The leaders of the railroad labor unions immediately announced that the cut would be resisted. No agreement could be reached through direct negotiation between labor and management, and the services of the National Mediation Board were requested in August, 1938. The Board was unable to mediate the dispute. The President then appointed a fact-finding committee to report on the problem. The decision of this com-

mission was not binding on either labor or management, and for a time it appeared likely that there would be a strike; but in November, 1938, the railroad executives decided to withdraw the proposed wage cut. It seems, however, that this problem may have to be faced soon again.

Railroad Consolidation.—Though some of these measures may aid in providing temporary relief for the railroads, it appears evident that, so long as the roads consist of a large number of independent lines, they will fail to enjoy many economies which might be theirs through consolidation. Efforts to induce the railroads to consolidate voluntarily, but according to a general plan evolved by the Interstate Commerce Commission, have met with but little success. As an alternative, it has been proposed that we have compulsory consolidation of the railroads. Some people would give the Commission the power, after mature deliberation and extended hearings on the subject, to effect such consolidations as might appear desirable from the point of view of securing efficient railroad operation. In some instances, these consolidations would probably appear to be contrary to the corporate interests of individual railroads, but it is argued that the private interests of a few railroads should be subordinated to the interests of the country as a whole in developing a sound national transportation system. It is said to be, after all, only a step from the Commission's present authority to control the extension of railroad lines and services to the power to order the consolidation of certain railroad properties. Moreover, it is argued that the railroads themselves would probably prefer compulsory consolidation to governmental ownership and operation, which might be seriously considered if efficiency in transportation cannot be achieved under regulation. However, compulsory consolidation should probably not be attempted unless we are willing to turn to government ownership in case the railroads refuse to cooperate. In the meantime, it might be desirable to try to bring about consolidation by relaxing the former requirement that such consolidation must conform to a general plan set up by the Commission. For example, the railroads might be allowed to consolidate as they see fit, subject to the approval of the Commission.

The Regulation of Transportation by Water.—Although much may be accomplished by the new legislation for regulating motor carriers, we must also face the fact that water carriers still remain quite largely outside the field of regulation. The Interstate

Commerce Commission has at present limited control over carriers by water by virtue of its control of the railroads. That is, where joint rail and water routes are used, and in cases where railroads are allowed to own water carriers, the Commission has jurisdiction. Other control over water transportation, such as that over Great Lakes carriers and those in the coastwise trade, was vested by an Act of 1916 in a separate organization called the Shipping Board. This control, however, does not apply to rates in anything like so great a degree as the control of the Interstate Commerce Commission over railroad rates, and it should be extended. Moreover, the question of whether certain water carriers charge low rates because they are, in effect, subsidized by the government should be carefully investigated. It is our contention that in the years to come the regulation of water carriers, including the control of rates and service, under present and future legislation, should be intrusted to the Interstate Commerce Commission, in addition to its present duties of regulating the railroads and motor carriers.

The Commission has had a high degree of success in the past in wisely administering legislation which, through most of the life of the Commission, has been notably defective in certain respects. The additional duties proposed here for the Commission might make it necessary for much work of a routine nature to be intrusted to clerical assistants, or for individual commissioners to handle some cases that come up, rather than having them decided by the Commission as a whole or by the larger divisions of the Commission previously mentioned. Nevertheless, the regulation of the transportation system should be centralized in a single agency, for only thus can real coordination be obtained and all types of carriers be adequately protected. The rate adjustments made for any one type of carrier will affect the ability of other types of carriers to earn a fair return on their investment, and it is unthinkable that different agencies should be allowed to make these adjustments for the several types of carriers, if conditions in transportation are ever to be stabilized.

The Recommendations of the Railroads.—There are many changes which railroad executives believe should be made in the regulation of railroads, in addition to the abandonment of the old consolidation plan. Some executives urge the repeal of the Denison Act, which requires railroads, upon order of the Commission, to make joint rail-water rates with the government barge lines, and

turn over traffic to them. Many would like to have a relaxation of the present rate regulations applying to short and long hauls, and the abandonment of Commission control over railroad extensions, acquisitions, and abandonments. Finally, it is sometimes suggested that the Commission's power to suspend railroad rates should be limited to cases in which certain persons or firms can show the prospect of irrecoverable injuries. However, it is doubtful how far we could go by way of relaxing railroad regulation and still avoid the chaotic conditions of the past.

The Case for Governmental Ownership and Operation of the Railroads.—In spite of the promising measures which have been taken in recent years, there are many people who believe that the railroad problem cannot be solved under a system of regulation, and that the federal government should take over and operate the railroads. Indeed, former Coordinator Eastman himself suggested that governmental ownership and operation may eventually be the best solution of our railroad problem. Those who hold this view advance many arguments in its support. In the first place, it is said that under governmental ownership and operation the objective would be efficient transportation and the promotion of the public welfare rather than private profits. It would only be necessary for the railroads to be self-sustaining under governmental operation; and profits, when made, could be used for the benefit of the general public or distributed in advance to railroad users in the form of lower rates, more adequate and safer service, or freedom from labor disputes through the payment of high wages to the railroad employees.

In the second place, it is contended that the management of the railroads would be as efficient under governmental ownership and operation as under private management—if not, indeed, more so. The railroad system, under governmental operation, would realize to the fullest extent those savings to be obtained from unified management—savings such as were realized under governmental operation during and after the World War and which were among the chief objectives in the plan for voluntary consolidation described in this chapter. Moreover, the cost of regulation would no longer exist and a saving in interest charges would be effected, since the federal government can borrow on its own bonds at a lower rate of interest than that charged the railroads as private corporations. As the result of efficient operation and the fact that profits would no longer be necessary, rates could be lowered, and

the centralized control over rates would insure the disappearance of personal and local discriminations.

Incidentally, it is held that the relations of the government to labor in the railroad industry would be more harmonious than those which have prevailed in the past between railroad labor and the railroad corporations, and that losses would no longer be sustained because of the activities of dissatisfied employees. Investors in railroad securities would also be benefited through the substitution of governmental obligations for those of the railroad corporations and the elimination of the question of railroad failures and receiverships. Finally, it is pointed out that the majority of the railroads in the world outside of the United States are owned and operated by governments, and that the trend appears to be in the direction of government ownership, rather than away from it.

The Case for the Continuance of Regulation.—Despite this imposing array of arguments, there is something to be said on the other side of the question. So far as the stated objective in railroad operation is concerned, there is, we believe, a clear case for governmental ownership and operation; but whether this objective would be realized in practice depends upon a number of other considerations, not the least of which is the efficiency of management under governmental operation. Even if we grant for the moment an efficiency of management under governmental operation comparable to that under private operation, is it likely that any great gain would be realized from the fact that the profit motive would no longer predominate? So far as the past is concerned, it is certain that the welfare of the people of this country would not have been greatly enhanced by the capture and devotion to public purposes of the profits made by the railroads since 1920. The total investment in the Class I railroads of this country amounted in 1930 to over 26 billion dollars. While the government would probably take over the railroads at something less than the railroads' own valuation of their property, it is probable that over 20 billion dollars' worth of government bonds would have to be issued for the purchase of the railroads. The railroads now have to pay fixed charges only on their bonds, since income to the stockholders is contingent upon net earnings, while under government ownership the total investment in the railroads would be represented by bonds upon which fixed charges would have to be met. On the other hand, the rate of interest would be less upon these

obligations than upon those of the railroads. The probable result would be, then, that the fixed charges which the government would have to meet would be in the aggregate somewhat less than the total of fixed charges and dividends which would be paid if the railroads should make the fair rate of return on their investment that was prescribed by the Commission. In other words, a saving could be realized through forsaking the profit motive, if efficiency of management could be maintained.

The question of efficiency of management is crucial. The arguments advanced above, supporting the view that governmental ownership and operation would be efficient, are all sound enough, but they leave out of consideration one very important factor—the human element in management. From a mechanical point of view, the railroads under governmental ownership would be organized in the form which appears most conducive to efficient operation; but what about the managers in charge of railroad operation? It might be difficult to find men of sufficient ability to manage a national railroad system successfully, for the railroad industry as a single unit would make the largest present industrial concern appear as a mere dwarf by comparison. Even if these "super-managers" exist, it is doubtful whether they would be chosen under our governmental system, in which political motives usually appear to control appointments—at least in part. If the right men were found by some method or other, would the government pay salaries high enough to attract them into the railroad service? Finally, if satisfactory managers could be attracted to the railroad industry, it is doubtful whether they would work as hard to hold down a job furnished by the government as one under private control of the railroads where their positions and salaries were dependent upon the results produced for the stockholders. Unless some way could be found to control satisfactorily the personal element in railroad management under government ownership, it appears that adequate service at reasonable rates might more readily be attained under regulated private management.[10]

In connection with the question of efficiency of management, it has been asserted that, if the government had owned and

[10] For a thorough and impartial discussion of this and other points concerning governmental ownership and operation of the railroads, see Eliot Jones, *Principles of Railway Transportation,* New York, The Macmillan Company, 1924, pp. 499-544.

operated the railroads during the years from 1930 to 1935, it would probably have incurred a railroad deficit of $10,000,000,000. The railroads under private management reduced operating expenses sharply during the depression years, while the government probably could not have done so, because of political pressure. In 1933, operating expenses for our railroads were 73 per cent of gross earnings, but operating expenses were 105 per cent of gross earnings in Germany, 107 per cent in Belgium, 112 per cent in Norway, 114 per cent in Denmark, 118 per cent in France, and 119 per cent in Italy.[11] In these foreign countries all or part of the railroads are owned and operated by the government. This inability of governmental railroad management to avoid recurring deficits is said to be a strong argument against governmental ownership and operation, for our private railroads have paid as high wages and have given as efficient and comfortable service as the government-owned railroads, in spite of the excessive operating expenses of the latter.

Again, in the matter of rate discriminations, it does not seem that governmental ownership and operation would help. Personal discriminations have already been eliminated for the most part, and local discriminations might easily continue under government ownership Who would want railroad rates to be adjusted between the different parts of the country by the same method as that which is used in distributing tariff favors? To go a step further, who would want expenditures for the maintenance and improvement of the railroads to be granted to the various districts of the country upon the same basis as that which is now used in passing out appropriations for the improvement of rivers and harbors, and the construction of post offices, court houses, and other public buildings? Political influence in railroading would endanger the efficiency of our transportation system.

From our war-time experience with governmental operation, it seems reasonable to suppose that the government might succeed in establishing more friendly relations with labor than those which exist at present between the railroad corporations and railroad labor; but it is to be feared that the new condition would be brought about through the payment of such high wages that railroad employees would become a favored class, to the prejudice of other members of the community. Finally, it appears that the inter-

[11] *Railway Age,* April 18, 1936, p. 669.

ests of the holders of railroad securities can be as well protected under regulation as under government ownership.

Such are the arguments which are commonly advanced for and against the governmental ownership and operation of the railroads. It is not our function to suggest to the reader the final conclusion to be arrived at out of this welter of opposing arguments, for it is the privilege and duty of a citizen to weigh the evidence pro and con and reach a decision for himself. Indeed, it is important that a decision be reached fairly promptly by our voters, for the matter of governmental ownership and operation of railroads may easily become the question of the hour in the relatively near future.

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1. Why are the railroads important in our present economic system?
2. What is the nature of the "railroad problem"?
3. What is meant by saying that the railroad industry is one of increasing returns? How does the concept of increasing returns differ from that of decreasing costs?
4. Why are railroads said to operate under conditions akin to those of joint costs?
5. Under what condition did the railroad industry operate during the early years of its life in this country? What abuses sprang up in connection with the railroads during this period? Why?
6. In what respects was the early legislation affecting the railroad industry defective? Explain fully.
7. What adjustments in railroad operation were made necessary by the World War? Why?
8. Why does consolidation in the railroad industry appear desirable?
9. What were the provisions of the Transportation Act of 1920 with regard to consolidation? What progress toward consolidation has been made under this law?
10. What were the provisions of this law with respect to railroad rates and earnings? Explain.
11. How did this Act attempt to control the issue of railroad securities and railroad service?
12. What was the fate of the railroads in the depression years of 1929 to 1933?
13. What change has apparently taken place in the nature of the demand for the services of the railroads? How was this change related to the railroad problem?
14. What was the significance of the railroad labor situation in connection with the railroad problem?

15. To what extent was the railroad problem due to the competition of other transportation agencies? Explain.
16. Why was the competition of water and motor carriers often characterized as unfair by the railroads? Were the contentions of the railroads with regard to this competition sound?
17. Summarize the main provisions of the Motor Carrier Act of 1935.
18. Is the Act likely to accomplish the purposes for which it was intended? Explain.
19. What other steps have been taken in recent years to provide relief for the railroads? Explain.
20. What improvements have recently been made in the equipment and operation of the railroad industry?
21. What further steps are essential to the solution of the railroad problem?
22. Why do some people contend that the only real solution of the railroad problem is governmental ownership and operation? Explain.
23. Why are other people quite as firmly convinced that the governmental ownership and operation of the railroads should be avoided, if possible?

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22 PUBLIC UTILITIES

THE RAILROADS, WHICH WERE DISCUSSED IN THE PRECEDING CHAPTER, ARE REGARDED AS PUBLIC UTILITIES BY SOME WRITERS, while others, though admitting that railroads are "public utilities" in many essential respects, prefer to treat them separately. This separation makes for convenience in discussion, for the railroads have been regulated very largely by the federal government, while the control of the public utilities has been carried on almost entirely by the state governments.

The Nature of Public Utilities

Natural Monopolies.—It is not easy to draw up a complete list of public utilities, since the items included under this heading change from time to time. Among the activities which have been classed as public utilities at one time or another, are street railways; water, gas, electric, telephone and telegraph companies; steamship lines; grain elevators; and stockyards—in addition to the railroads. When used in conducting such activities, private property is no longer strictly *private*, because in such uses it becomes "affected with a public interest."

What is it that causes a business to be classed as a public utility? One thing is the possession of the characteristics which make it a "natural monopoly." A natural monopoly is a type of business in which competition usually results in duplication of equipment and great waste. Imagine, for example, the waste which would occur if a city were served by two competing street railway systems, with duplicate tracks throughout the town, and duplicate rolling stock, power lines, and operating personnel. Each of these companies might be confidently expected to have a higher cost of production per unit of service than the cost would be if a single transportation company were operating in this city.

Most public utility businesses require a huge original investment in plant and equipment, and have large fixed or overhead costs. Such businesses enjoy increasing returns as they increase

the volume of business transacted with a given amount of productive facilities, since the additional business increases only operating costs, and not fixed costs, while the total revenues expand considerably. Consequently a public utility company undertakes to get as much business as possible and, when two utilities offer the same service to the same customers, their relations often degenerate into cutthroat and destructive competition. Such a condition, marked by violent rate-cutting, is likely to last until one company is ruined or absorbed by the other, or until the competitors see the light and agree to combine. Even if competition were as economical as monopoly in these businesses, it might still be desirable to have some of them operated as monopolies. In telephone service, for example, it is important, in the interests of convenience, for all telephone users to be subscribers in a single company, rather than to have them distributed among several companies. As a result of these and other considerations, governmental units have come to recognize the need for monopoly in such businesses, and have permitted and even encouraged monopoly operation.

Essential Products.—A second characteristic of public utilities is that their products, whether services or commodities, are generally regarded as vitally necessary to the public. In our large cities, thousands or hundreds of thousands of people look to surface, subway, and elevated railway lines for transportation, and their dependence upon other public utilities, such as electric companies, is so great that a stoppage of service, even for an hour or two, may lead to considerable inconvenience or even to genuine suffering. In the field of communication many individuals and businesses depend largely upon the telephone or telegraph service. In general, the demand for public utility services is inelastic. To be sure, the demand for (say) gas, on the part of some users at least, may be elastic because of the existence of satisfactory substitutes, but the demand for heat, light, or power in some form or other is relatively inelastic.

Franchises.—A third characteristic of public utilities is that many of them are dependent, for the right or power to operate, upon privileges or favors granted them by the public through various governmental units. Street railways, and water, gas, and electric companies, must use public streets or highways, or the areas above or below such streets and highways, in the conduct of their business, and are given grants, or "franchises," by state and local governments for this purpose. Moreover, governments

sometimes grant public utilities the right to condemn private property for necessary purposes or to use public water power in their business.

Differential Rates.—A fourth characteristic of public utilities is that a company, such as one supplying electric current, is sometimes permitted to sell its service to several classes of consumers for different purposes at different prices. It is usually quite impossible to determine the exact cost of supplying the service to any particular class of consumers and, as a result, the rates charged are likely to be arbitrary and to be based upon "what the traffic will bear."

The Regulation of Public Utilities

With public utility businesses operating as monopolies in their particular areas, producing essential economic goods for which the demand is relatively inelastic, and depending in many instances upon special privileges or favors granted by the state, it is clear that the unregulated operation of these businesses by private enterprisers might result in great evils, including extortionate rates for inferior service and unfair discrimination between different consumers or classes of consumers. The possibility of operation of an anti-social nature led to early regulation of public utilities—so early, indeed, that the problems connected with public utilities were almost completely local in character, and their regulation could scarcely have been assumed to fall within the constitutional powers of the federal government. As a result, the regulation of public utilities has been conducted largely by the states.

Public Utilities Commissions.—This regulation has not ordinarily been undertaken directly by state governments. Rather, the regulatory powers have been delegated to commissions. Some of the better-equipped public utility commissions have powers similar to those exercised by the Interstate Commerce Commission in regulating the railroads. They often control rates and fares, extensions and abandonments of service, the issuance of securities, the prevention of discrimination between different customers and classes of customers, the quality of the service, the valuation of utility properties, and accounting methods. Of all these many items, the most difficult and important is, of course, the regulation of rates.

The Regulation of Rates.—The states, and their public utilities commissions, were at first left quite free to regulate the rates

charged by public utilities. The courts, including the United States Supreme Court, refused to interfere with what was so obviously an exercise of powers granted to state governments by the Constitution and would neither set aside prescribed rates nor themselves set up rates for the utilities. Eventually, however, the court attitude changed and the Supreme Court decided that if rates set by state governments or their commissions were so unreasonable as practically to destroy the value of the properties of public utilities, they could be set aside as violating the "due process" clause of the federal Constitution. Thereafter, the commissions, while trying to protect the interests of consumers, have been kept from setting public utility rates at so low a figure that they would be confiscatory with respect to the properties of public utilities; and the general idea has developed that rates should be regulated in such a way as to enable the utilities to earn a "fair rate of return on a fair valuation of their properties."

The Problem of Valuation.—It is all very well to say that the utilities should be allowed to earn a fair rate of return on a fair valuation of their properties, but quite another matter to apply the principle to specific cases. The first difficulty is to establish a fair valuation. The property of a public utility scarcely has a value, in the usual economic sense of exchange value, since it is seldom bought and sold and is hedged about with restrictions and regulations which do not affect ordinary property. The value of a piece of industrial property is usually determined by the income it is capable of earning. But in the case of public utilities, earnings depend upon rates and these rates (if they are to represent a "fair return") cannot be set until after the "fair valuation" has been determined. Therefore, the commissions have had to turn to other methods of evaluating the properties of public utilities. The problem of valuation has usually been approached by way of "prudent investment cost" and "reproduction cost."

Prudent Investment Cost.—Prudent investment cost is ordinarily taken to mean the amount of capital actually invested in a public utility enterprise, corrected for capital expenditures dishonestly made or made in a clearly wasteful or extravagant manner. There are several possible ways of arriving at prudent investment cost. It is sometimes said that the par value of the stock of a public utility represents satisfactorily the amount of the actual investment in the business. This criterion, however, could not be applied to all public utilities, since some have issued stock with no

par value. Moreover, there may be only a vague relationship between the par value of a utility's stock and the actual value of its property. Some public utilities are overcapitalized, and have outstanding an amount of stock well in excess of the value of their properties. For example, a public utility company, just starting in business and short of cash, may wish to acquire a piece of property without paying cash for it. To induce the owner to accept stock in lieu of cash, the company may have given him stock which has a par value well above the cash value of the property that is being acquired. Of course, to allow public utilities which are overcapitalized to earn a fair return on their capitalization, would be to grant them an excessive return on the actual value of their property.

Again, the par value of a company's stock may at one time have represented accurately the value of its property, but no longer do so because through poor management the utility has lost some of its original assets or had them depreciate in value. Or the property of a company may increase in value without the increase being reflected in the amount of capital stock outstanding. In either case, a fair rate of return on the basis of capitalization would give a return on the actual value of the property which was either larger or smaller than it should be. Consequently, capitalization has little to recommend it as a basis for valuation.

Another proposal is to assume that the market value of a public utility's stock represents the present value of its property. About all that can be said for this method is that a valuation could be readily obtained by finding the total value of the company's stock on the stock exchange. Such a valuation would be most unsatisfactory, however. The value of the company's stock depends largely upon the rate of return which prospective owners hope to obtain by holding it, and the total value of its stock tends to be its present and probable future rate of earnings, capitalized at the current rate of interest. Since the total value of the stock depends upon the company's earnings, to make the earnings dependent upon the total value of the stock would be to reason in a circle. If a company were at present making an excessive return upon its actual investment, its stock would tend to sell well above par. And if the present value of its stock were taken as its valuation, a fair rate of return on this valuation would permit the continuance of an excessive rate of return upon the actual investment.

Original Cost.—If we were to use prudent investment cost as a method of valuation, it would be necessary to find a satisfactory method of converting the term into action. This might be done, it is often said, by taking prudent investment cost to mean the actual original cost of a public utility's properties, adding the cost of additions and improvements, and deducting any depreciation in the properties or loss of assets. It is argued that such a valuation is eminently fair to all concerned. It grants a public utility a fair return on the capital actually invested in the business, as of the present time, and the utility has no right to claim better treatment. Moreover, it protects consumers from having to pay rates which would give the company a fair rate of return upon an excessive valuation of its properties. Finally, the valuation on the basis of original cost, once ascertained, would not change except when actual changes in investment occurred in the future, and it would provide a stable basis for rate regulation.

But there are some drawbacks to this method of valuation. One is the obvious difficulty of ascertaining original cost. Many public utility properties were acquired long years ago, and records of the transactions may have been lost or destroyed, if indeed they were ever kept. If a company originally acquired property by giving the owner stock instead of cash, should the original cost of the property be construed to be the par value of the stock given, or an estimate of its cash value at the time? Or if, at some time in its career, a company has bought out competitors, either through cash purchase or the exchange of securities, and, in order to be rid of the competitors, paid an excessive price for their properties, should original cost be interpreted to mean the price actually paid or only the construction value of the properties? Should an allowance be made the company for the original cost of promoting the company, of building up good will, and of acquiring a franchise and, if so, how large an allowance? How can we prevent companies from padding their costs, if original costs are used as the basis for valuation? These and other questions suggest that there is considerable room for error in estimating original cost.

Even if it should be possible to ascertain original cost accurately, there is no assurance that this method of valuation would be fair to public utility companies and investors at all times, since it does not take into account changes in the general price level. The original cost method gives a fixed valuation to a public utility company's property, and a fair rate of return on this valuation

means a relatively fixed money income. In a period of falling general prices, this stable money income would give increased purchasing power to the company and its stockholders, and impose a correspondingly heavy burden on the consumers, while in periods of rising prices it would bring decreased purchasing power for company and stockholders, and the consumers would be obtaining public utility services at bargain prices. This objection is not so serious as it sounds, however, for public utility commissions do not guarantee the utilities a stable money income. They merely try to regulate rates so that utilities will *normally* make a fair rate of return on the value of their property. Even if the rates are not reduced in a period of falling prices, the volume of business done at these rates will likely decline to such an extent that a utility's real income will not be enhanced unduly; and if rates are not raised in a period of rising prices, the increased volume of business at these rates may serve to keep the utility's real income from declining severely. However, the long-time upward or downward trends in general prices may serve to affect, either favorably or unfavorably, the purchasing power of the income received by public utility companies.

It is also said that the original cost method of valuation tends to discriminate between the consumers of the services of different utility companies. If one company's plant was constructed and its property acquired at a time when prices and costs were high, its consumers would have to pay rates sufficiently high to give the company a fair return on its high original cost. At the same time, the customers of another utility may be charged much lower rates because this company's plant was constructed and its property acquired at a time when prices and costs were low. Finally, the original cost method, when first introduced, may work a hardship upon persons who have bought the stock of public utility companies because of the high actual earnings of the companies and high returns paid on the stock. When the companies are subsequently limited to earning a fair return on the original cost of their properties, the dividends may be sharply reduced so that the stock will decline in value and deprive the owner of a part of his investment.

Reproduction Cost.—The principal alternative to the use of prudent investment cost for valuation purposes is valuation on the basis of the reproduction cost of public utility properties. In applying this method, the cost of reproducing or replacing a

company's properties is estimated and this figure is adjusted for depreciation, or the supposed difference in value between the actual properties and similar new properties. Of course, if the properties are not allowed to depreciate, an adjustment is not necessary. Valuation on the basis of reproduction cost is a more recent development than valuation on the basis of original cost, and is more flexible and therefore more readily adjustable to changing business conditions. Moreover, it is said to be in stricter conformity with the dictates of economic theory. Since business enterprisers ordinarily plan future production on the basis of prospective prices and prospective costs, rather than upon the basis of costs incurred in past production, it is held to be more logical to evaluate public utility properties for rate-making purposes on the basis of reproduction cost, rather than original cost.

However, it is difficult to get a definite valuation by the method of reproduction cost, for several obstacles stand in the way. Should reproduction cost be taken to mean the cost of constructing identical productive facilities or substitute facilities which would have the same total productivity? Should it be estimated as under present conditions and methods of construction or under methods and conditions which existed when the company's productive facilities were constructed? What would it now cost to acquire the company's franchise or build up the good will which it developed in the past? These questions are more readily asked than answered, and in the absence of satisfactory answers the proper valuation of a company's properties on the basis of reproduction cost is a debatable matter.

The flexibility of valuation on the basis of original cost may be an advantage or a disadvantage. When the general price level falls, the cost of reproduction falls also, so that a lower valuation for a property is appropriate, while the reverse is true in a period of rising prices. Assuming that the rate of return remains unchanged, the money income of the company will decline as the purchasing power of money increases and increase as the purchasing power of money declines, so that the real income of the company and its stockholders should remain fairly constant. In general, a fluctuating money income and stable real income would be preferable to a stable money income and fluctuating real income. However, this adjustability means that the valuation of a company would never remain stable for any great length of time, since it would change with changes in the general price level. As a result,

a company's valuation would be constantly in a state of flux and neither the company nor the regulating commission would have anything definite to go on. The cost of reproduction method is advantageous in that it does not discriminate between the consumers of different utility companies, as does the original cost method; for two substantially similar plants would probably be given approximately the same valuations on the basis of reproduction cost, however different their original cost may have been because they were constructed at different times and under different cost conditions. Furthermore, the use of reproduction cost is likely to cause plants to be built efficiently and at low cost, since original cost will not affect valuation or earnings, while under the original cost method there is an incentive to make the original cost high for valuation purposes.

The Fair Rate of Return.—In addition to deciding, upon some basis or other, the valuations to be placed upon the properties of public utility companies, public utility commissions have to decide upon a fair rate of return on these valuations. This, also, is a difficult matter. The commissions must protect the public against the monopoly powers of public utilities, but at the same time the companies must earn enough to cover costs of production, so that they may render efficient service, maintain their productive facilities, and attract new capital for purposes of expansion and improvements. Moreover, in addition to deciding the rate of return they would like the utilities to earn on the basis of their valuations, the commissions must determine the prices for services which are most likely to produce the desired rate of return for the utilities, keeping in mind the uncertainty of business conditions and possible variations in the cost of producing the services. A given set of prices will produce different rates of return for different companies with identical valuation if the managements of the companies differ in efficiency. While problems of valuation and fair rate of return have attracted more attention than the problem of arriving at prices which will bring in the fair rate of return on the fair valuation, this latter problem is a very trying one.

Public utility valuation and rate regulation are so complicated that they are often dealt with in complete volumes, but enough has been said in the present chapter to enable the reader to appreciate their difficulty. Under the circumstances, it is not surprising that attempts by several agencies to determine the fair valuation and fair return for a public utility company have resulted in valuations

which varied by hundreds of millions of dollars, and in proposed earnings in which the largest exceeded the smallest by 100 per cent.

Another Method of Rate Regulation.—The difficulties of the fair-return-on-the-fair-valuation approach are so great that in some cases commissions have abandoned this method of regulating rates and adopted what might almost be called a rule-of-thumb method. In Massachusetts, for example, the commission is said to take into consideration principally the economic situation of the company. It considers whether the company is paying dividends on its stock, whether the stock is selling at or above par on the market, whether the company is providing adequate depreciation reserves and is accumulating a reasonable surplus, and whether its operating and maintenance expenses are being increased or decreased under current business conditions—and only then are they ready to hand down a decision in a rate case. The commission makes no attempt to give the public utilities a particular percentage rate of return on the value of their properties, but tries merely to control rates so that the companies may pay dividends high enough to keep the value of their stock above par and permit the companies to market additional securities, when necessary, at not less than par. This plan seems to have much to recommend it, but its standing, in the light of past utility decisions of the Supreme Court, is uncertain.

The Success of Public Utility Regulation.—It was necessary for the state governments to delegate the regulation of public utilities to public utility commissions, for direct regulation by state legislatures would scarcely be feasible. But it must be admitted that commission regulation has not been entirely satisfactory. This may be accounted for in part by the fact that the commissions have been set to work solving problems for which there are no wholly satisfactory solutions. Some commissions have been given adequate powers and ample expert assistance, so that they have been able to operate successfully, but the reverse is true in many cases.

Many conditions among public utilities which the commissions were expected to remedy have continued to exist. They have often been unable to prevent utility companies from inflating or writing up the value of their assets, or from selling securities to a much greater total value than the aggregate value of their assets. Indeed, it is probable that total overcapitalization in the public utility industry runs into billions of dollars. While the commis-

sions have usually discounted to some extent the claims of public utilities with respect to the value of their properties, it is nevertheless true that the official valuations of these properties have often greatly exceeded the amount of the actual investment. A fair rate of return on an excessive valuation is equivalent, of course, to an excessive rate of return on a fair valuation.

Even if the valuation were perfect and the rate of return fair, the common stockholders of a utility company might still receive an unduly high return on their investment, because of the low fixed rates of return to holders of bonds and preferred stock. When the valuation is excessive, and the fair rate of return represents a very high return on total actual investment, the earnings of common stockholders on their investment may run to four or five times the nominal fair rate of return. It is true, also, that commissions have been unable to prevent excessive discrimination between different classes of customers. Of course, no one contends that all customers should be charged the same rates for (say) electricity, regardless of the amount of power used or the hours at which they use it, but electric companies have been known to sell a large part of their power to other utility companies at less than cost, and to industrial users at but little above cost, while charging domestic or residential consumers from fifteen to twenty times the average cost of generating and transmitting the current.[1]

Weaknesses of the Commissions.—While the regulatory problems faced by the commissions are very complicated, it is probable that much of the ineffectiveness of regulation has resulted from the inadequacy of the powers granted to some commissions and to defects in their personnel. For example, in 15 of the 48 states, public utility commissions are either wholly or partially lacking in jurisdiction over the electric light and power industry. Only 32 states have granted their commissions the authority to prescribe a uniform system of accounting for public utilities, and yet, without something of this sort, it is almost impossible to determine the facts needed for valuation and rate-making purposes. The issuance of securities by utilities is supervised in only 25 states, and in fewer still can the commissions exercise any real control over the uses made of the funds derived from the sale of securities.

Members of the commissions are elected by popular vote in

[1] C D. Thompson, *Confessions of the Power Trust,* New York, E. P. Dutton & Co, Inc, 1932, pp 216-227.

some 20 states, although it would seem that positions requiring so high a degree of technical knowledge might better be filled by appointment. Both in these states and in others, a considerable staff of assistants would be desirable, but such staffs as there are may be described as wholly inadequate. The commissions themselves have more than three members in only 11 states, and are consequently often too small for effective work. Many commissions are handicapped by reason of insufficient funds, and in a few cases their functions are not clearly defined in the state laws.[2] Despite these weaknesses, the commissions have done much by way of setting up standards of service and safety for the utilities, although, as was previously stated, they have not been especially successful with respect to valuation and rate-making.

Interstate Public Utility Activity.—Two recent developments in the public utility field have conspired to make state regulation of the industry less effective than formerly. Many years ago, the business of the public utility was almost entirely local in character, but at present the services of a utility are often sold, at least in part, in other states than the one in which the company is located. Electric power is the public utility product which enters most largely into interstate commerce. This interstate business has created a curious "no man's land" of regulation. The Supreme Court has held that state commissions have no power to regulate rates or other matters in the case of electric power sold at wholesale by a company in one state to a company in another state for distribution in the latter. However, when a company in one state sells a public utility service directly to consumers in other states, the Court has ruled that such business may be regulated by the states unless and until the federal government itself attempts regulation. These interstate activities of public utility companies are pretty clearly a part of interstate commerce and subject to federal control, but they are a complicating factor in state regulation.

The Development of Holding Companies.—Another factor which has arisen to hamper state regulation of public utilities is the development of holding companies. Holding companies, as we shall see, may exert a tremendous influence for good or evil in the public utility field, but they are scarcely amenable to state control. They are connected with the public utility industry

[2] This information is from C. M. Clay, *The Regulation of Public Utilities*, New York, Henry Holt & Company, Inc., 1932, pp. 144-149.

only through owning, directly or indirectly, a controlling interest in the stocks of actual public utility operating companies. Since they produce no utility services themselves, they do not come under the jurisdiction of public utility commissions; and, since many of them operate in two or more states, they have not been readily controlled by the individual states. The problem of the holding companies has become so important that in 1935 the federal government made an attempt to control them and their activities. Before considering this attempt at federal control, we must look into the organization and practices of these companies.

Holding Companies

The Nature of Public Utility Holding Companies.—Any company which holds the stock of other concerns may be called a holding company, but the term is usually reserved for companies that own a controlling interest in the stock of other companies and actively direct the affairs of these corporations. In the public utility field, a "first-degree" holding company is a corporation that owns a controlling interest in the stock of one or more operating utilities (those which really produce and sell electricity or some other service to the public) and that directs the business activities of the operating company or companies. A "second-degree" holding company will own a controlling interest in the stock of one or more "first-degree" holding companies, each with a group of operating companies under its control. Similarly, there may be holding companies of "third degree," "fourth degree," and so on. Holding companies, of course, are not limited to the public utility field. They exist in many of our major industries, but the problems which they present are probably of greatest significance in the field of public utilities, and it is primarily in this field that holding companies above the first degree are found.

The Financial Functions of Holding Companies.—The champions of holding companies in the public utility field claim that many advantages result from the operation of these corporations. A principal function of holding companies is to furnish capital to operating companies. Public utilities require a heavy investment in fixed capital, and much new capital is needed from time to time for extensions and improvements. Public utilities in towns and small cities have often secured from local sources the funds with which to start in business, but they have often found it difficult to raise funds for extensions and improve-

ments. They have been in a poor position to appeal to investment bankers for funds to be obtained through the issuance of securities, because they were small and unknown and lacked diversity of resources. In this connection, holding companies have been of assistance. They have accepted the securities of the small operating companies in exchange for needed funds, later recovering their outlay by marketing their own security issues, which were readily salable because the holding companies were comparatively large and well known and possessed resources (through the operating companies) which were well diversified in both character and location. Even when the security market has not seemed to be in condition to absorb new securities, the operating companies have often obtained funds from their holding companies by direct loans. Through the operation of holding companies, the individual operating companies are able to secure capital on better terms than those on which they could secure it for themselves. It is claimed that such financial support has helped to improve the quality and reliability of service in small communities, and to replace small, inefficient plants with large, modern generating stations.

Other Holding Company Functions.—Another benefit credited to the holding company is its ability to save money for its operating companies by acting as their purchasing agent. By purchasing at one time machinery, equipment, materials, and supplies for a number of operating companies, the holding company can buy in very large lots and obtain, in addition to lower prices, such advantages as better service, quicker delivery, and a prompter and more satisfactory adjustment of claims than the individual operating companies. Again, the holding company, with a number of operating companies under its wing, can afford to have a department or a subsidiary company to provide the operating companies with expert construction and engineering service at a price lower than the operating companies would have to pay outside concerns. The holding company can also give its small operating companies the benefit of high-class managerial ability and the experience which would otherwise be available only to the largest companies. Finally, it is often possible for holding company organizations to supply service to farms, and to small communities which could not themselves support public utilities.

It would seem that, if there were no offsetting disadvantages, the holding company would be the fairy godmother of the public

utility industry, transforming, as by a wave of the wand, inefficient, high-cost operating companies into efficient, low-cost enterprises, and furnishing managerial and other services, materials, supplies, and capital to the operating companies on most reasonable terms. Without the holding company, it might be argued, many of our public utilities would be unable to operate, or could continue in business only by charging higher rates than at present. Why should anyone want to destroy or regulate so useful an organization? But there is, unfortunately, another side to the picture.

The Pyramiding of Holding Companies.—If operating companies may enjoy these several benefits through the device of the holding company, it would seem that most of these advantages could be realized through the assistance rendered by a first-degree, or at most by a second-degree holding company. But our existing holding company systems have not stopped at the second degree. Many of them have at the top a holding company which is several times removed from the operating companies in its fields. According to a well-known writer on financial organization:

> Out in Oregon, you find a little company called the Yawhill Electric Company. It belongs to the Portland General Electric Company. But the Portland Company belongs to the Pacific Northwest Public Service Company. This might be thought to be the parent organization. It controls the public utilities of Portland, the gas company in Seattle, and street railways and other utility companies in various towns. But this is not the end of the maze. The last-named company belongs to the Central Public *Service* Corporation, which owns other utility systems in Delaware, Maryland, and Virginia. And that in turn belongs to the Central Public *Utility* Corporation, which owns various other holding companies, with utilities and other sorts of enterprises from Maine to Oregon.
>
> But this is still not the end. The Central Public *Utility* Corporation is held by a super-holding company called the Central Public Service *Company*. Why the little Yawhill Electric Company in Oregon, the Tri-City Gas Company in Alabama, the Bridgewater Electric Company in Maine, and the Lower St. Lawrence Power Company in the Province of Quebec, plus a maze of companies (including the Compagnie d'Éclairage Électrique in Haiti) in a dozen or more states, should all be huddled in this same holding company nest, no one can explain. And the interests which support these weird structures are powerful. Nothing short of action by the federal government, and

plenary power in the agencies entrusted with the job, can clean up such situations.[3]

This should not be considered an exceptional case, for it is asserted that, in some public utility systems, the top holding company is ten to fourteen stages removed from the actual operating companies. As to geographical distribution, it is well known that the Electric Bond and Share Company had operating companies in 36 states, and that each of eight other utility systems had operating units in from 11 to 29 states. While such complicated and widespread systems may not be justified from the point of view of the operating companies or the public, it is clear why the holding companies themselves desire to build up these complicated systems.

Power and Profits.—The reason is this: As holding company is piled upon holding company, power and profits become increasingly concentrated in the hands of the few men who control the topmost holding company. The point may be illustrated by the following hypothetical example given by the Federal Trade Commission:

Suppose there are 100 local power companies, the aggregate total investment in which is $1,000,000,000, each owned and operated by a separate corporation. The total investment might have been raised by the sale in the aggregate of $200,000,000 of common stock, $200,000,000 of 7 per cent cumulative preferred stock, and $600,000,000 of 6 per cent bonds. If these companies are permitted by public authorities to earn 8 per cent on the total investment, or $80,000,000 annually, of this, $36,000,000 would be required to pay the bond interest and $14,000,000 as dividends on the preferred stock. This leaves $30,000,000 for the common stockholders, either to draw as dividends or to use in further expansion of the business. This amounts to 15 per cent on the common stock investment and has been made possible out of the 8 per cent earned on the total investment only because the major portion of the total invested funds was furnished by two classes of investors whose per cent of return is limited.

Suppose, however, a particular group of promoters would like to make more than 15 per cent from these power company investments, and for this purpose forms a holding company with a total capital of $200,000,000 (the amount of the common voting stock of the operating companies), consisting of $100,000,000 of 6 per cent collateral trust bonds or 6 per cent debentures, $50,000,000 of 7 per cent cumulative

[3] J. T. Flynn and P. H. Gadsden, "The Holding Company Bill," *Forum and Century,* May, 1935, pp. 259-265.

preferred stock, and $50,000,000 of common stock. This group may be able to furnish the common stock money and persuade others to furnish the bond and preferred stock money, or, furnishing the common stock money, they may persuade the holders of the common stock of the local operating companies to exchange those stocks for this cash, together with the collateral trust bonds and preferred stocks. Now the $30,000,000 earned by the local operating companies on their common stock equities would accrue to the holding company. Out of it $6,000,000 would go as interest on the bonds and $3,500,000 would go as preferred dividends. This would leave $20,500,000 for the group of promoters who hold the common stock of the holding company, which amounts to 41 per cent on their investment of $50,000,000.

This group, however, might not be satisfied with this arrangement, or it might not have as much as $50,000,000 to invest. Suppose, therefore, that, instead of providing one holding company, it provides ten, dividing the local operating companies among them, the aggregate capital of the ten companies being the same as in the preceding case and of the same proportional structure in common stocks, preferred stocks, and bonds. Now suppose that the promoters organize a super-holding company with a total capital of $50,000,000 (the amount of the common stock of the ten subsidiary holding companies) consisting of $25,000,000 of 6 per cent bonds, $12,500,000 of 7 per cent cumulative preferred stock, and $12,500,000 of common stock. The promoters furnish the common stock money, thereby retaining for themselves the entire voting power in the whole pyramid of companies and constituting themselves the ultimate beneficiaries of the group's earning power, and sell the other securities to the investing public. The $20,500,000 of income left after paying interest and dividends on the bonds and preferred stocks of the operating companies and of the subsidiary holding companies accrues to this super-holding company. Out of it, $1,500,000 is required for interest on the super-holding company's bonds and $875,000 for dividends on its preferred stock. This leaves $18,125,000 for the common stockholders, or 145 per cent per year on the investment of $12,500,000 made by these promoters.[4]

This illustration shows that a small group of promoters, by investing $12,500,000, could gain control of $1,000,000,000 worth of operating companies, and receive their money back 1½ times each year—and the topmost holding company in this example is only of the second degree! By controlling more operating companies and carrying the holding company structure to greater heights, even better results could be obtained. Moreover,

[4] Senate Document Number 213, 68th Congress, 2nd Session, pp. 173, 174, cited in C. D. Thompson, *Confessions of the Power Trust*, pp. 181-183.

this illustration assumes that each successive holding company has acquired *all* the common stocks of lower companies, which would not be necessary for purposes of control. It also counts as profits of the topmost company only the income received indirectly from the operating companies' earnings. But holding companies also make profits from fees charged for various kinds of services performed for the operating companies. All in all, it is evident that the operations of holding companies may be very profitable to the "insiders."

The Duping of Investors.—The above description suggests that, when the business is profitable, the small group of common stockholders of the topmost holding company is in a position to get most of the cream. And, when the business is unprofitable, most of the loss is borne by the holders of the other securities, since they have furnished most of the invested funds. In this connection, it should be noted that holding companies have sometimes been guilty of unloading very poor securities on investors. A first-degree holding company holds as its principal assets the common stock of the operating companies which it controls. It has, then, a claim, partial or complete, on the residual earnings of these companies. On the basis of this stock, however, the holding company often sells one or more issues of bonds and possibly three or four issues of preferred stock, while retaining control in the hands of a small number of persons through ownership of the common stock, or such part of it as has voting power. The holding company may pay exorbitant prices for the stock of operating companies and then proceed to sell an amount of its own securities which is far in excess of the real value of the securities which it owns.

While there may be justification for the issuance of bonds by a first-degree holding company, the fact remains that, as bonds are issued by holding companies further and further removed from the operating companies, these "bonds" become distinctly less secure than the common stock of many industries. The same is true, and to an even greater extent, of the preferred stock of high-degree holding companies. Take, for example, the case of a holding company of the fifth degree. Its assets consist largely of the stock of other holding companies. This stock represents a partial, residual claim, four times removed, on the residual earnings of the operating companies in the system. However attenuated this claim might seem to us to be, the fifth-degree

The Farmers' Income.—When the Agricultural Adjustment Act was passed, many people doubted that the income of the farmers would be increased substantially by the program. It was expected, to be sure, that farm prices of basic products would increase; but the farmers' income depends, of course, upon prices times quantities sold. With prices to consumers raised by both reduced production and the processing taxes, it was thought that the quantities taken by consumers might fall off to such an extent that the farmer would not gain much despite the higher prices and cash benefits received. However, the statistics for farm income since 1933 leave no doubt that total farm income increased materially under the A.A.A.

The A.A.A. *vs.* Other Administration Policies.—It was also argued that the program for agricultural adjustment conflicted with other policies of the Roosevelt administration—notably the attempt to increase purchasing power for consumers in general—since prices of controlled products would probably rise by more than the increase enjoyed by the farmers. This argument did not prove valid, since the farmers received benefits to offset the processing taxes and greater receipts to offset the rise in prices caused by restricted production. Hence, the only net decrease in consumers' income would seem to have been that part of the collections from processing taxes which went into paying the expenses of administering the farm program, rather than into benefits for the farmers.

It was thought, also, that total consumers' purchasing power might be reduced by reason of farmers using their income increases to pay off debts, rather than to purchase finished goods; whereas if the additions to income had not been taken away from other consumers, they would have been used to buy consumers' goods. But the indexes of farmers' purchases that we have, such as sales by mail-order houses and sales of automobiles in rural areas, seem to indicate that the farmers used no small part of their increased incomes for the purchase of finished manufactured products. And even if they did pay off old debts instead, how would their creditors use these payments, if not for the purchase of economic goods?

According to Secretary of Agriculture Wallace, the farm program was beneficial to consumers, as well as to farmers, since it was aimed to restore a "fair exchange value" for farm products and to enable farmers to purchase other goods. He insisted that

consumers gain nothing in the long run by getting farm products at less than the cost of producing them. Agriculture, he said, is an essential industry which must be maintained, and to this end the prices of farm products must be kept sufficiently high to cover costs of production. He argued that consumers do not escape this necessity when for a time they fail to pay these necessary prices, but simply postpone the payment to their own disadvantage.[6]

There was some strength, however, in the criticism that the A.A.A. program conflicted with the attempts of the administration to bring about recovery in manufacturing industries. The processing taxes, through which the funds were raised to pay benefits to farmers, were levied on the first processors of the farm products. They therefore operated to bring increased costs to manufacturers, and may have been a stumbling block to recovery in industries using basic farm products as raw materials.

Class Legislation.—We now turn to certain criticisms which appear to be more serious from the economic point of view. One may properly question whether it is wise at any time for the government to support a particular industry at the expense of other sections of our population and, in this case, to pay the farmers to do something which it would have been to their interests to do in any case. Under the A.A.A. the consumer was taxed (if the processing taxes were shifted to him) in order to pay the farmer to restrict production and thus be enabled to charge the consumer higher prices. Clearly, the Agricultural Adjustment Act was legislation intended to benefit one class of people at the expense of others.

According to administration supporters, the wisdom of class legislation depends, at least in part, upon the length of time during which the policy of discrimination is followed. An economist who would condemn a policy of this kind as a permanent feature of our economic system might tolerate it as an emergency measure. At any rate, said the supporters, it must not be supposed that this is our first experience with legislation that benefits some members of the community at the expense of others. Our protective tariff legislation, which economists have been condemning for decades, does much the same thing, in that it benefits certain people (the owners of the protected industries) at the expense of those who are consumers. Surely it is the height of inconsistency to praise

[6] *Yearbook of Agriculture, 1935*, p. 5.

the protective tariff and at the same time to condemn the farm program on the ground that it is class legislation.

The Processing Taxes.—Was it wise to secure the funds required for the payment of benefits, by levying taxes upon the first processors of basic agricultural products? Might it not have been better to obtain this necessary revenue in some other way, so that the farmer could have received the entire benefit of the increased prices which resulted from restriction of output? In theory, at least, it would probably have been desirable to secure the revenue in some other way (say from income taxation) in order to help the farmers more extensively and to interfere less with the recovery of manufacturing industries; and also because processing taxes, if shifted to consumers, fall more heavily upon the poor than upon the rich. That is, these processing taxes were regressive. In practice, however, the receipts from income taxes and other progressive taxes are not always sufficiently elastic to produce adequate revenue in years of depression, so that it may have been necessary to use processing taxes, or other taxes similar in nature, to insure the collection of sufficient revenue.

The Administrative Problem.—There is no doubt that the farm program presented a difficult problem in administration. It would have taken a tremendous amount of supervision to make sure that all of the millions of individual farmers actually restricted their acreage by the promised amounts, that they did not turn to raising other basic products, and that they did not offset the effects of acreage reduction by cultivating their remaining land more intensively. It would seem that opportunities for petty graft abounded under the A.A.A.

Our Exports and the A.A.A.—We have noted that both the basic farm products, and the manufactured articles made from them, were exempt from the processing taxes when they were exported. However, the prices of the exported basic products were raised by the restriction of production, and the costs of exported manufactured goods were raised, in all probability, by their dependence upon raw materials which had risen in price. Thus, our export trade was adversely affected by the farm program, and the production of the basic products in other parts of the world was stimulated to some extent.

Our cotton exports in 1934 were only 4,799,000 bales, as compared with 8,419,000 bales in 1932, and an annual average of 8,250,000 bales from 1925 to 1929. Wheat exports, which were

97,000,000 bushels in 1932 and averaged 133,000,000 bushels from 1925 to 1929, were only 19,000,000 bushels in 1934 and 3,000,000 bushels in 1935. Exports of corn amounted to 2,000,000 bushels in both 1934 and 1935, a considerable decline from 9,000,000 bushels in 1932 and an average of 23,000,000 bushels from 1925 to 1929. Tobacco exports were 473,000,000 pounds in 1934, but declined to 353,000,000 pounds in 1935, as compared with 432,000,000 pounds in 1932 and an average of 508,000,000 pounds from 1925 to 1929.

This decline in exports, however, did not seem so serious to supporters of the farm program as to some other people. Since, from the national point of view, the purpose of exporting is to become able to import, and since our imports are severely curbed by our protective tariff, a decline in exports may prevent us from making further foreign loans or getting into other difficulties in the field of international trade. Moreover, if the farm program did result in a decline in our exports of farm products, it merely continued a movement which had been in progress for many years because of our tariff policy.

The Permanence of the Farm Program.—Probably the most serious criticism of the farm program was the charge that the A.A.A., once instituted, could not be given up and would turn into a permanent policy. It can scarcely be stated too emphatically that the agricultural adjustment program was not desirable as a permanent solution of the farm problem in the United States, because it did nothing to reduce the number of farmers in the country or the amount of land available for the production of the basic crops. When the demand for a manufactured product suffers a permanent decline, the industry reacts by producing fewer units than formerly and by allowing a part of its productive facilities to lie idle. Eventually, however, the industry tends to readjust its productive capacity to the changed conditions of demand, and only then can it be said to have met the problem created by the decline in demand. The A.A.A. program led only to the first of these steps, that is, it induced the farmers to produce less than before and to allow a part of their productive agents to remain unused. It did not lead to the apparently necessary curtailment of the land, labor, and capital employed in the agricultural industry.

The Secretary of Agriculture realized perfectly well that the A.A.A. was merely an emergency measure, that it took out of

cultivation land which was efficiently cultivated as well as land which was not, and that it did not control satisfactorily the bringing of new land under cultivation and the shift of production on government-leased acres to non-basic products. According to the Secretary, the temporary and varying reductions in acreage under the A.A.A. seriously disturbed the farm economy, for it upset established rotations of crops and the relations between landlords and tenants. He suggested that it was more costly to induce farmers to keep a part of their acreage out of cultivation than it would have been to rent a corresponding acreage made up of whole farms. The purchase of submarginal land by the government would probably have been still better.[7]

Despite the fact that many, if not most, people felt that the A.A.A. should be merely a temporary program, there was always a possibility that it might be continued indefinitely. Once the government had established the practice of paying cash benefits to the farmers, it threatened to be a most difficult matter, from a political point of view, to discontinue these benefits when it became economically desirable to do so. Hence, we were in some danger of seeing the farm program remain as an undesirable but permanent feature of our economic system, in much the same way that the protective tariff, created more than a century ago to protect infant industries, has remained to plague us long after some of these infants have become industrial giants.

The End of the Agricultural Adjustment Program.—Arguments as to the wisdom or folly of the agricultural adjustment program came largely to an end in January, 1936, when the Supreme Court found the Act unconstitutional by a 6 to 3 vote. It was held that the law constituted an invasion of states' rights, since the Constitution did not give the federal government the power to regulate agriculture, and its power to control interstate commerce could not be stretched to include the regulation of agricultural production. Moreover, it was held to be improper for the federal government to purchase compliance with a federal program, and thus attain indirectly that regulation of local affairs which had been specifically denied it by the Constitution. While agriculture can hardly be considered a matter of local concern from an economic point of view, it appears to be purely so according to this interpretation of the Constitution.

[7] *Yearbook of Agriculture, 1934*, pp. 20-22.

The Soil Conservation Program

The Soil Erosion Problem.—Since the federal government was unwilling to see American agriculture return to its previous chaotic state and since no permanent solution of the farm problem had been found, the government launched forth upon the discovery of a new farm program. In its search, it came upon the problem of soil erosion, upon which we commented in the preceding chapter. Satisfactory methods of combating soil erosion have been developed. Several types of close-growing vegetation, such as grass and alfalfa, are helpful in holding the soil in place and reduce water and soil losses very materially. Amazing results may be achieved merely by rotating such soil-conserving crops with the money crops, such as corn and cotton.

Results of Vegetation Control.—The Department of Agriculture has collected much information showing how vegetation may be used in preventing soil erosion. On an experimental plot near La Crosse, Wisconsin, where the soil loss was 51.5 tons to the acre when the soil was uncultivated and 59.9 tons to the acre when planted to corn continuously, it was found that the loss could be reduced to .003 of a ton per acre by planting the land to bluegrass continuously. On another plot near Bethany, Missouri, where the soil loss was 112.48 tons to the acre when uncultivated and 61.16 tons to the acre when planted to corn continuously, the loss was decreased to .22 of a ton per acre by planting to alfalfa continuously. In the La Crosse experiment, the loss of water was 15.9 per cent of rainfall when the land was uncultivated, 19.2 per cent when used for corn continuously, and only 2.9 per cent when planted to bluegrass continuously. On the Bethany plot, the water loss was 25.98 per cent of rainfall on uncultivated soil, 27.38 per cent when planted to corn, and only 3.40 per cent when planted to alfalfa continuously. Finally, in a third experiment, it was discovered that soil loss could be reduced from 28.0 to 6.3 tons per acre, and the rainfall loss from 14.2 to 11.7 per cent, by rotating cotton, wheat, and sweet clover instead of using the land continuously for cotton.[8]

Other Control Methods.—A method known as strip-cropping is also helpful in preventing soil erosion under favorable conditions of cultivation. Strip-cropping means the alternation of close-growing crops with the money crops, such as corn or cotton, in

[8] *Yearbook of Agriculture, 1935*, pp. 299-305.

strips of a certain width, depending on the degree of slope and other factors. This method of controlling soil erosion often requires help from mechanical methods, especially on the steeper slopes, for the land is in danger from erosion whenever it is planted to cultivated or money crops. In such cases, methods such as terracing the land and using broad, contoured channel ways for drainage have often proved helpful in reducing sheet erosion and severe gullying.

The chief difficulty with erosion control in the past has been to get the farmers actively interested in it. The individual farmer has often felt that he could do little about soil erosion by himself, or has lacked the financial resources which would permit him to make the attempt. Under unfavorable farm conditions in the past, farmers have considered it necessary to use all of their land for money crops and to keep it planted to such crops year after year, in order to make ends meet. In 1936, the government decided, after the A.A.A. was declared unconstitutional by the Supreme Court, to undertake a program of erosion control which would also help to solve the main farm problem.

The Soil Conservation Act.—Consequently, in February, 1936, a previously existing Soil Conservation Act was amended and enlarged for this purpose. The Act appropriated about $500,000,000, and authorized the Secretary of Agriculture to restore the pre-war relationship between farm and city incomes for those farmers who should comply with prescribed methods of soil conservation and erosion control. For two years, the government was to make payments directly to cooperating farmers, as a reward for their voluntary support of the program of soil conservation. Beginning with 1938, however, federal payments were to be made only to persons in states which had passed authorizing legislation and had formed a conservative plan acceptable to the Secretary of Agriculture.

In the administration of the law, two classes of benefit payments are available for farmers who cooperate. Payments for soil conservation are granted to farmers for transferring a part of their soil-depleting base acreage to soil-conserving crops or uses. Farmers may obtain this type of payment on any number of acres up to 15 per cent of their general soil-depleting base acreage, 35 per cent of their cotton base acreage, 30 per cent of their tobacco base acreage, and 20 per cent of their peanut base acreage. The payments are on a basis of so much an acre, and average about

$10 an acre for the country as a whole. The other payments are called soil-building payments, and are available for farmers who adopt certain approved practices to restore soil fertility, such as new seedings of legumes or perennial grasses; seeding soybeans, cowpeas, and the like, for green manure; the application of limestone; and the use of strip-cropping or terracing methods. Such payments are limited to the same number of dollars as a farmer had acres of soil-conserving crops on crop land in 1936.[9]

The relation of this conservation program to the main farm problem is obvious. If the farmers use a part of their land for crops which will be effective in preventing soil erosion, they cannot use it for producing the basic money crops. In this way, it is planned to kill two birds with one stone—to achieve some highly desirable results by way of controlling soil erosion, and at the same time to prevent the overproduction of the basic crops.

1936-1937 **Results.**—The soil conservation program was in operation in 1936, but its effects on agricultural production were obscured by the great drought of that year—a drought second only to that of 1934, which was said to be the worst in American history. The 1936 drought reduced some basic crops substantially, as is shown in Table 25. The cash income of our farmers, which

TABLE 25.—PRODUCTION OF CERTAIN BASIC CROPS IN RECENT YEARS[a]

Year	Wheat (bushels)	Corn (bushels)	Cotton (bales)	Tobacco (pounds)
1934	526,393,000	1,461,123,000	9,636,000	1,081,629,000
1935	626,344,000	2,303,747,000	10,638,000	1,297,000,000
1936	626,461,000	1,529,327,000	12,399,000	1,153,083,000
1937	875,676,000	2,651,284,000	18,946,000	1,552,601,000
1938	930,801,000	2,542,238,000	12,008,000	1,455,970,000

[a] Sources: *Statistical Abstract of the United States, 1937*, pp. 637–641, and *Chicago Tribune*, December 19, 1938.

was $6,387,000,000 in 1934, and $7,090,000,000 in 1935, increased, because of high prices, to $7,850,000,000 in 1936. In 1937, weather conditions were favorable, and the output of most basic farm products was large. However, prices were well maintained, and the farmers' cash income increased further, to $8,500,000,000.[10]

[9] *Yearbook of Agriculture, 1937*, pp. 16, 17.
[10] *Statistical Abstract of the United States, 1937*, pp. 606-609.

An Estimate of the Soil Conservation Act.—It seems likely that the Soil Conservation Act has a better chance for survival than the old Agricultural Adjustment Act. It has the advantage of being planned to operate eventually as a state program, carried on with financial assistance from the federal government. This method of procedure has proved to be constitutional in the past in other connections, as, for example, in the construction of highways. Under the soil conservation plan, the farmer is not paid for *not producing* the basic crops. Rather, he is paid for taking positive action in cooperating in a national program of soil conservation, and any restriction of output that may occur comes about indirectly. Moreover, the financing of the plan is not dependent upon a system of unpopular processing taxes. The control of soil erosion is a pressing problem, and one which is undoubtedly national in scope. Therefore, this may be judged a proper sphere of action for the federal government.

Otherwise, the Soil Conservation Act is open to many of the criticisms raised against the Agricultural Adjustment Act. It tends to make the basic farm products scarcer than they would otherwise be, and causes farmers to take a course of action which they would not have followed on their own initiative. It presents similar administrative difficulties, and tends to conflict with other policies of the administration. It is not quite so widely open to attack on the grounds of class legislation, since the problem of soil erosion is important to everyone; but it tends to keep the domestic prices of our farm products above the world prices, so that our exports of these products remain at low ebb. Finally, the program may be continued far into the future, regardless of our future need for erosion control, because of its indirect effects on farm production.

These criticisms assume that the soil conservation program will succeed in controlling agricultural production, but this premise may be seriously questioned. The Secretary of Agriculture has stated that the Soil Conservation Act helped to stabilize supplies of farm products in 1936, by encouraging the more extensive use of land. But he recognized that the Act was not a direct measure for production control, and predicted that the return of normal weather conditions would bring the problem of agricultural surpluses back to life. This prediction was borne out to some extent in 1937 and 1938. We should note, also, that the

long-run effect of soil conservation will be to increase, and not to decrease, agricultural production.

Recent Developments and the Future

The Farm Act of 1938.—Early in the 1937-38 business recession, the prices of farm products in general slumped badly. With substantial reserves of the basic products on hand (as a result of the large crops in 1937), and with the probability of very large, if not record, crops in 1938, it appeared that further farm legislation was necessary, and so Congress approved a new Farm Act in February, 1938. This Act provided for the continued operation of the Soil Conservation Act in normal times. In years of overproduction of farm products, however, a rather stringent method of control goes into effect.

Marketing Quotas.—According to this law, there is "overproduction" whenever the corn crop and "carryover" exceed 2,795,000,000 bushels; the wheat crop and carryover, 945,000,000 bushels; the cotton crop, 19,500,000 bales; or whenever the rice crop is 10 per cent, or the tobacco crop 5 per cent, greater than normal. When there is overproduction of one of these commodities, the Secretary of Agriculture may set up compulsory marketing quotas, after receiving the approval of two-thirds of the producing farmers voting in a referendum. The amount of the total marketing quota is to be equal to a year's normal consumption and exports, plus a certain percentage, minus the estimated carryover at the beginning of the marketing year and the amount received as seed or for livestock. The total marketing quota is prorated to states, counties, and individual farms, in proportion to normal yields of their acreage. For the individual farmer, the marketing quota is the amount of a commodity that he may sell without penalty.

Acreage Allotments.—Control of agricultural production is also to be facilitated by acreage allotments. These acreage allotments are not compulsory in themselves, but they furnish the basis for setting up the marketing quotas, and farmers who produce and sell the basic products in amounts exceeding their marketing quotas must pay penalties, on the excess, of 15 cents a bushel for corn and wheat, and 2 cents a pound for cotton. Moreover, basic commodities produced in excess of marketing quotas may not be fed to livestock for the market, given away, or traded for other economic goods. They have to be stored on the farm or in warehouses. The acreage allotments for each commodity are also

made by the Secretary of Agriculture, and equal altogether the acreage required to produce a year's normal requirements for consumption and export, plus an arbitrary amount for stocks, minus the amount carried over from the preceding year.

Crop Loans.—The Act provides for loans to farmers on their excess supplies of the basic products. The Commodity Credit Corporation is directed to make loans on wheat, when the price is below 52 per cent of parity, or when the estimate of the current crop is larger than the amount of a normal year's consumption and exports. The parity price for a good, as under the A.A.A., is one which will give that commodity a purchasing power (in terms of the goods which farmers buy) equal to its purchasing power in the base period which, for most of the goods, is the period from 1909 to 1914. The amount loaned on wheat may vary between 52 and 75 per cent of the parity price.

Loans on corn are made whenever the price is below 75 per cent of parity, or when the crop estimate exceeds a normal year's consumption and exports. These loans may also vary in amount from 52 to 75 per cent of the parity price. Cotton loans are made on terms identical with those for wheat loans. All of these loan rates apply only to "cooperators," that is, to farmers who comply with the requirements of the program as prescribed by the Secretary of Agriculture. "Non-cooperators" get no loans at all, or much smaller loans than those granted to cooperators. It is provided, further, that no loans need be made on a commodity produced by those who, voting in a referendum, reject the imposition of marketing quotas for that commodity. In view of these provisions, a high degree of cooperation with the Secretary of Agriculture was expected from American farmers.

Since the 1938 wheat crop, plus carryover, was certain to exceed a normal year's consumption and exports, a program of wheat loans was put into effect early in 1938. These loans averaged about 60 cents a bushel, and the wheat used as collateral had to be held either in commercial warehouses, or in approved granaries or bins on the farm. The loans will bear 4 per cent interest, and will run for seven months in the case of commercially stored grain, or until May 31, 1939, in the case of wheat held on the farm. Farmers who did not exceed their acreage allotments for soil-depleting crops by more than 5 per cent, were eligible for these loans. Farmers may regain possession of their wheat at any time by repaying the loan, plus interest and storage charges. When the loans mature,

the farmers have the privilege of surrendering their wheat to the government as full payment of their obligations.

In the fall of 1938, corn loans of 57 cents a bushel were made available for farmers in the commercial corn area of the Middle West. It was expected that many such loans would be taken out, since the loan rate was about 10 cents a bushel above the market price for corn. Farmers were able to obtain these loans, let the government keep the corn as security, and buy corn for their own feeding from non-cooperators at the low market price. Corn loans for farmers outside the commercial area were set at 43 cents a bushel, while non-cooperating farmers were entirely ineligible for loans.[11]

Crop Insurance.—Besides continuing the Soil Conservation Act, the new Farm Act provided for crop insurance for wheat only, beginning with the 1939 crop. A federal crop insurance corporation was set up, with capital of $100,000,000 and a 1939 appropriation not to exceed $20,000,000, to insure wheat against losses due to drought, flood, lightning, tornado, hail, winterkill, wind, plant disease, and insect infestation. The insurance may cover from 50 to 75 per cent of the average yield on a farm, over a representative period of time. Reports in December, 1938, indicated that 234,485 farmers had applied for insurance on the 1939 wheat crop, and that 103,000 had already paid their premiums in wheat turned over to the government.[12]

The 1938 Wheat Program.—Because of the falling prices of farm products and the large 1937 crops, it was thought desirable to put the new Farm Act into immediate operation. The 1938 wheat program called for a reduction from 81,000,000 to 62,500,000 acres. Farmers who planted within allotments received soil conservation benefits of 12 cents a bushel on the normal yield of the planted acres. Every acre planted in excess of allotments was to be penalized at the rate of 96 cents a bushel on the normal yield, the penalties to be deducted from the benefits. Land taken from wheat production must not be put into other soil-depleting crops. No acreage allotments were made to farmers whose normal wheat production for market is less than 100 bushels.[13]

The 1938 Corn Program.—The area planted to corn was cut from 99,000,000 to 94,000,000 acres, under the 1938 program.

[11] *Chicago Tribune,* November 11, 1938.

[12] *Champaign-Urbana (Illinois) News Gazette,* December 4, 1938.

[13] *Champaign-Urbana (Illinois) News Gazette,* February 28, 1938.

Benefit payments for allotted acres were 10 cents a bushel on the normal yield, while a penalty of 50 cents a bushel was to be assessed on the normal yield of every acre planted in excess of allotments.[13] It was expected that a vote would have to be taken among corn growers, to decide the question of marketing quotas, but the Secretary of Agriculture apparently decided to avoid the referendum by revising the estimate of the corn crop downward.

The 1938 Cotton and Tobacco Programs.—The 1938 cotton program called for the planting of 27,000,000 acres, as compared with 44,000,000 acres which were once planted in cotton. Through this reduction, the 1938 crop was held down to about 12,000,000 bales, or approximately enough for this year's consumption and exports. The immense carryover of 13,000,000 bales from 1937's record crop will probably not be reduced, however. It was expected that loans of about 9 cents a pound would be made, eventually, on about 5,500,000 bales of the new crop.[14] Tobacco growers, also, had a control program for 1938 which included, among other things, the production of 705,000,000 pounds of bright, flue-cured tobacco, and a penalty of 50 per cent of the market price on tobacco sold in excess of marketing quotas.[15]

Appraisal of the 1938 Farm Act.—An elaborate program, under the 1938 Farm Act, has been worked out for 1939, but it seems unnecessary to give the details of this program, since it appears probable that the Act will be changed during the 1939 session of Congress. The 1938 allotments were not received with very good grace by the farmers. From various parts of the country came reports that farmers were up in arms, or near revolt, because of the allotments given them; and charges of favoritism and double-dealing with respect to allotments were heard as between states, counties, and individual farmers. Of course, it is difficult to know how much of this alleged unrest was real and how much merely represented wishful thinking on the part of anti-administration newspapers. But it served at least to call attention to the fact that the 1938 Farm Act is exceedingly difficult to administer, in both making and enforcing the plans. The Act is long and complicated, covering as it does some fifty pages of fine print; and it has been remarked facetiously that a farmer will need to send his son through law school if the son is to be a successful farmer himself.

[14] *Chicago Tribune,* May 18, 1938.
[15] *Ibid.,* May 4, 1938.

In the fall of 1938, it was necessary to hold referendums among growers of several crops, on the question of marketing quotas for 1939. Such quotas were approved by cotton growers, but were rejected by three groups of tobacco growers and by rice growers. These unfavorable votes may lead to a revision of the Farm Act. Indeed, a new bill has already been introduced into Congress, calling for governmental price-fixing, at the average cost of production level, on such amounts of important crops as are needed for the domestic market, and for surpluses of these crops to be turned over to the Secretary of Agriculture for marketing abroad at the best prices obtainable.

The 1938 Farm Act was superior to the Agricultural Adjustment Act in that it depended upon general revenues, rather than processing taxes, for funds. Otherwise, it was quite similar to the A.A.A., except that it seemed to be more highly restrictive. Practically every criticism formerly leveled at the A.A.A. may be applied to the 1938 Farm Act Many people have held that the new Act is clearly unconstitutional. This is always a hazardous sort of prediction; but it may be said that, if this Act survives the test of constitutionality, it will be because of a changed temper on the part of the Supreme Court since the rendering of the A.A.A. decision, and not because of any inherent superiority of the new Act.

The Permanent Solution.—It is unpleasant to have to suggest that the 1938 Farm Act, like the two Acts which preceded it, apparently does not provide a long-run solution of the farm problem. It sets up a complicated mechanism which may work successfully in adapting the *rate of operation* in agriculture to the demand for the products, but this is a short-run type of adjustment. If the present program should be discontinued after a few years, the main farm problem would probably arise again with undiminished vigor. A long-run solution requires the adjustment of the *size* or *capacity* of agricultural production as a whole, and not merely its rate of operation, to the demand for farm products—and the new Act does nothing to decrease the number of farmers or to reduce their land holdings available for growing the basic crops.

The new plan should be supplemented with a careful study of land uses in the United States, to ascertain the purposes for which land in various parts of the country may best be employed. The main farm problem, it will be remembered, resulted from an expansion of farming to the point at which it could provide heavy

exports after taking care of domestic needs, followed by the loss of foreign markets and changes in domestic conditions to which the productive facilities of agriculture have never become adjusted. Therefore, it is frequently suggested that the federal government should buy up, in different parts of the country, marginal land, which was formerly devoted to the cultivation of the basic crops, and retire it from production permanently or until it is once more needed. It may be necessary, also, for the government to develop agencies which will facilitate the movement of workers from farming into other occupations, in case farmers can be found who are willing to accept such assistance. These transfers would be well-nigh impossible in a period of depression, but could be accomplished eventually. It may be desirable, finally, for us to use less land for production and more for consumption, developing more national parks and using land more extensively as sites for homes.

Fortunately, progress is already being made along some of these lines, for the Resettlement Administration has begun to acquire poor farming land and is promoting its development for other uses. In 1936, for example, this agency obtained options on 9,500,000 acres of poor farm land in 207 projects. Most of the options were taken up at about $4.50 an acre. The new uses for the land included forty-six recreational projects, thirty-two for the propagation and protection of migratory waterfowl, and thirty-one for the Indian service, all of which gave employment to 55,000 relief workers.[16]

The Tariff and the Farm Problem.—If our traditional tariff policy should be thoroughly reversed in the reasonably near future, it might not be too late to recapture some part of our former export markets for farm products; and this achievement would lessen the need for taking the steps that we have just recommended. Our present policy with respect to the tariff, under the Reciprocal Trade Agreement Act, offers some hope in this direction. Farmers should not be too quick to believe newspaper statements to the effect that the trade agreements are disadvantageous to them, because of increased imports of farm products into the United States in recent years. Most of these imports resulted from causes quite unrelated to the reciprocal trade agreements, and, while large in absolute amounts, have almost always constituted an insignificant fraction of production.

[16] *Yearbook of Agriculture, 1937*, p. 23.

Monopolies and the Farm Problem.—It seems, also, that a permanent solution of the farm problem depends largely upon solving the problem of monopolies and trusts. In the past, our farmers have been handicapped by having to sell their products in a highly competitive market while doing most of their buying in a market which is to a considerable degree monopolized, or at least controlled. In the long period of good business prior to 1929, many of our manufacturing industries, being monopolistic or semi-monopolistic in character, were able to maintain stable prices in the face of improved methods of production and falling costs of production. Quite apart from the effect of this situation in producing the depression of 1929, it made it difficult, if not impossible, for our farmers to get prices for their products which would enable them to share in the general prosperity of business.

Later, when the great depression broke in 1929, these monopolistic and semi-monopolistic industries were still able to maintain prices to a very large extent. This they did by restricting production sharply, by turning off employees, and by reducing their purchases of raw materials. This course of action made it difficult for farmers to sell their raw materials and foodstuffs, and the uncontrolled prices of farm products had to bear the brunt of the depression liquidation. Thus, in a sense, the farmers under the various farm programs are only giving our industrialists a taste of their own medicine. The farm problem would have been much less severe if competitive conditions had been maintained in industry, and its solution in the future will be easier if the trust problem is solved successfully.

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1. How was the size of basic crops affected by the A.A.A. program of 1934?
2. What happened to the prices and stocks of farm products under the Agricultural Adjustment Administration?
3. How were farm incomes affected by the operation of the Agricultural Adjustment Administration?
4. Did the Roosevelt administration, through the A.A.A., attempt to enrich the nation by making all kinds of economic goods scarce? Explain.
5. Comment on the distinction between agricultural adjustment and agricultural reduction.
6. How did the farmers react to alleged attempts to "regiment" them, through the A.A.A.? Why?

7. Would the A.A.A. program have eventually led to complete socialism? Explain.
8. Was the Agricultural Adjustment Administration extremely wasteful in carrying out its program? Explain.
9. Why was the agricultural adjustment program said to be in conflict with other policies of the Roosevelt administration? Explain.
10 Do consumers sometimes buy farm products at prices too low for their own good? Why?
11. Why was the Agricultural Adjustment Act called class legislation? Was it to be condemned on this account? Why?
12. Should the revenues for supporting the farm program have been derived from processing taxes? Why?
13. Could the A.A.A. program have been successfully administered?
14. How were our exports affected by the farm program? Why?
15. What was the principal danger in connection with the Agricultural Adjustment Administration? Explain.
16. On what ground was the A.A.A. program declared unconstitutional by the Supreme Court?
17. How can soil erosion be controlled by the use of certain types of vegetation? What results have been achieved by this method?
18. What other methods are employed for controlling soil erosion?
19. What are the chief provisions of the Soil Conservation Act?
20. Explain the dual purpose of this Act.
21. Was the soil conservation program superior or inferior to the A.A.A. program? Why?
22. Why was new farm legislation passed in 1938? Explain.
23. Compare the provisions of the Farm Act of 1938 with those of the two preceding farm Acts.
24. Does the Farm Act of 1938 offer a satisfactory, permanent solution of the main farm problem? Why?
25. What steps should be taken in the near future with respect to agriculture? Why?
26. In what way is the farm problem related to the trust problem? Explain.

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21 TRANSPORTATION

SPECIALIZATION AND LARGE-SCALE PRODUCTION ARE FUNDAMENTAL CHARACTERISTICS OF THE PRESENT ECONOMIC ORDER. An individual does not attempt to produce for himself all of the many economic goods he needs for the satisfaction of his wants, but instead specializes in a single task or a limited number of tasks, trusting that he may obtain, through the process of exchange, the other economic goods that he desires—goods which have themselves been produced for the most part on a large scale by other groups of specialists. Large-scale production brings with it many economies, but we often hear it said that the extent to which large-scale production (and its accompanying principle of division of labor) can be applied is largely limited by the size of the market for the products. The extent of the market is in turn greatly dependent upon the adequacy and efficiency of the means of transportation which have been or can be developed.

The Importance of the Railroads.—In the United States, as in other industrially advanced countries, the railroad was for many years the most important single means of transportation. In 1937, there were 239,112 miles of railroads in this country, counting only single trackage between any two points, as compared with a total of 254,037 miles in 1916. If second, third, fourth, and other trackage is included in the total, the figure for 1937 was 415,399 miles. The total investment in our Class I railroads (which means every railroad that has a net operating revenue of at least one million dollars per year), including the investment in road and equipment, materials and supplies, and cash, amounted to about $26,000,000,000 in 1935. The same group of roads employed 1,065,624 workers in 1936, as compared with 2,022,832 employed in 1920. Finally, the Class I railroads originated about 958,830,000 tons of revenue freight in 1936, as against an average of 1,279,197,000 tons from 1926 to 1930, and carried revenue freight amounting to 339,246,000,000 ton-miles in the same year, as compared with an average of 427,234,000,000 ton-miles in the

years 1926 to 1930.[1] The term "freight originated" refers to freight received from shippers, and does not include freight received from another railroad.

Clearly, it is of importance to everyone that an industry of such magnitude and such vital importance in our economic system should be kept strong and vigorous, and capable of rendering cheap, efficient service. And yet, since the beginning of the great depression of 1929, and even before, our railroads have not been able to earn sufficient net revenue to enable them to maintain existing plant and equipment satisfactorily and attract sufficient new capital to make possible the new construction projects and betterments in general which are so necessary for continued efficient operation. Indeed, many railroads have failed to meet their obligations and have gone into receivership, while our railroads as a whole have operated at a net deficit, after paying interest charges, for several consecutive years. How were the railroads brought to such a condition? What can be done to improve their lot? These are the questions which we examine in the present chapter, and, in doing so, we shall find it necessary to delve into the affairs of the other forms of transportation in the United States. But our first task is to consider the chief economic characteristics of the railroads.

Economic Characteristics of the Railroads

The railroads furnish an outstanding example of an industry which tends naturally to become a monopoly. That is, the railroad industry is one in which free competition is wasteful, if not actually ruinous, and in which maximum efficiency and lowest costs of production can be obtained only when competition is eliminated or at least greatly restricted.

Increasing Returns in Railroading.—One of the characteristics of railroads upon which the tendency to monopoly depends is what is usually called increasing returns. A railroad is a business that requires a heavy original investment. The interest upon borrowed capital, together with other fixed charges such as the rentals of leased lines, taxes, and amounts to be set aside for sinking funds to provide for maturing obligations, make up an important part of total costs of transportation, and a part which remains the same whether the railroad runs at full capacity or at only part

[1] *Statistical Abstract of the United States, 1937,* pp 370-390, and *Railway Age,* January 1, 1938.

capacity. As the traffic handled by a railroad increases, the operating costs increase, of course, but total costs do not increase in proportion to the increase in traffic, because of the large element of fixed costs. It follows, then, that as a railroad comes to be operated at full capacity, instead of at half capacity, the business that is handled doubles but the costs of transportation do not double, and, if the rates charged are assumed to be relatively constant, net earnings of the railroad increase.

There is nothing mysterious about the tendency described in the preceding paragraph, nor is the tendency peculiar to the railroad industry. Any industry which has a considerable amount of plant and equipment will find that it is more economical to run at or near full capacity, rather than at some lower level. Nor should one be led to jump to the conclusion that the railroad is necessarily one of those industries which are characterized by economists as "industries of decreasing costs." The concept of decreasing costs, as usually described in connection with price determination in the long run, is concerned with the average cost per unit of product which the industry would experience as it adjusted itself to different volumes of production *through changing the amount of plant and equipment* and other productive factors devoted to production. Thus, an industry which would have a lower average cost of production per unit when its productive capacity and amount of plant and equipment used were large than when capacity and amount of plant and equipment were small, is to be described as an industry of decreasing costs. But, at either a large or a small volume of production and amount of plant and equipment, any concern in the industry would find it more profitable to run at full than at part capacity, and would experience increasing returns in the sense that a railroad may experience them. The concept of decreasing costs, therefore, refers to the experience of an industry as a whole as it changes its productive capacity, while the concept of increasing returns as applied to the railroads refers to the experience of one concern in an industry as it more or less completely utilizes a given amount of productive equipment. It may be that the railroad fits into both classes, but the one does not follow from the other.

However, the tendency to increasing returns, as described above, is of particular importance in railroading, because it is more pronounced in the railroad business than in most other lines of production. As a result of this tendency, any gain in the volume

of business handled is welcomed by a railroad, while any loss of traffic is a serious matter, and consequently, under a system of competitive rates, a wild struggle for traffic usually ensues.

Joint Costs in Railroading.—A second important characteristic of the railroad business is that it operates under conditions akin to those of "joint costs." A railroad, of course, ordinarily furnishes only a single service, transportation; but a given train often carries a wide variety of articles—some of high and others of low value; some in carload lots, others in less than carload lots; some for long distances and others for short distances. The result is that the exact cost of a given unit of transportation cannot be discovered. What part of the total cost of operating a train for an 800-mile run, for example, should be charged to a ton of coal which is being carried for 63 miles in conjunction with 80 or 90 cars full of other commodities, of different values per pound, being carried for different distances, in lots of different sizes? It follows, then, that the rates charged by railroads for their services in connection with any particular lot of goods must be more or less arbitrary, being based upon a notion as to "what the traffic will bear" rather than upon actual unit cost of production of the service.

We have already shown that the tendency to increasing returns in railroading appears most clearly when a larger volume of traffic than formerly handled is carried at approximately constant rates. Under conditions of competition, however, it does not take a railroad long to discover that it will be wise, at least from the short-run point of view, to add to its volume of traffic even if it has to reduce rates to attract the new business. As long as any new traffic will bring in enough revenue to cover the special costs of handling it, and in addition contribute something toward the costs which would persist whether or not the new business is taken on, it is profitable for a railroad to go after new traffic. Unfortunately, however, rate-cutting does not usually stop with the first cut. Unless the road with the increasing traffic has really attracted some business which would not otherwise have been carried, it has increased its own traffic at the expense of some other railroad or railroads, and one cut in rates usually leads to another, until business is being carried at rates insufficient to cover even the operating costs, not to mention the fixed costs. This process of competitive rate-cutting has often been described as "cutthroat competition."

The Development of Railroad Regulation

The American Railroad Industry Under Competition.—In spite of the fact that the railroad industry is one in which competition tends to be wasteful, the construction and operation of railroads in this country went on under conditions of practically unrestricted competition for more than fifty years. Railroads were built far in advance of the needs of the territories to be served by them, and the pressure upon the railroads, with their large unused capacities, to go out and get business, at whatever cost, was irresistible. The result was severe and destructive competition, and rate wars were of frequent occurrence. In addition, certain other pernicious practices, such as local and personal discriminations, sprang up.

Local Discrimination.—The most important type of local discrimination was that in which a given shipment of goods would be carried a long distance at a lower rate than that charged for carrying it a shorter distance. For example, as between New York City and Chicago, a low rate on a given commodity would be likely to prevail because of competition among several railroads operating between these two great terminals, while a railroad would charge a higher rate on this same good as between New York and some intermediate point at which competition with other railroads did not exist. Sometimes the rate charged to the intermediate point was the sum of the through rate from New York to Chicago and the local rate from Chicago back to the intermediate point. So long as the through or competitive business paid for the special costs of handling it, and contributed something to the other transportation costs, it was profitable for the railroad to take it. Moreover, the rates to the local or intermediate points would not usually have been lowered if the railroad had given up the competitive business, for the local traffic would then have had to bear both the operating costs and the fixed costs in their entirety, whereas the through or competitive traffic contributed something toward the fixed costs.

Personal Discrimination.—The pressure to get business, when railroads had unused capacities, manifested itself also in personal discrimination, which means charging one person more than another for substantially the same service, or giving one person more service than another while charging the two the same rate. Favors of this sort were granted by means of a great many devices which

are too numerous to note here, and were accorded chiefly to the more powerful shippers, that is, to those who had the largest quantities of commodities to be transported. The effect of widespread personal discrimination is to reduce the railroads from the status of common carriers to that of contract carriers, or carriers which undertake each particular bit of transportation service on the basis of a separate agreement as to service and rate.

Attempts to Restrain Competition.—Groups of railroads in different parts of the country at times became mindful of the ruinous nature of competition, and entered into agreements among themselves with the intent of restricting competitive activity. At times the subject of the agreements was rates, and the railroads would promise to maintain a given rate structure for a certain period of time. At other times, pooling agreements were entered into, and the railroads undertook to pool their traffic or the earnings from traffic, and to divide the business or the profits from it according to some prearranged ratio. While agreements of this sort were not punishable by law prior to 1887, they were nevertheless unenforceable at law, and there was every incentive for the railroads to attempt at times to evade the provisions of the agreements. As a result, most of these agreements did not enjoy long life.

Early Railroad Regulation.—The disastrous effect of competition on the railroads, the complaints of shippers concerning local and personal discrimination, the fear of monopoly power under rate and traffic agreements, the speculation and fraud which pervaded railroad finance, and the attitude of railroad officials and executives toward the public, were some of the causes which influenced Congress to begin a long career of railroad regulation by passing, in 1887, the Act to Regulate Commerce. The legislation pertaining to the railroads has been constantly changing since that time, but it was only after almost thirty-five years of regulation that anything like a constructive approach to the railroad problem was adopted in our railroad legislation. It will be impossible in this chapter to analyze in any detail the provisions of the various Acts which have been passed in regulating the railroads, but it is essential to an understanding of the railroad problem of today that the chief defects of the early railroad legislation should be pointed out. The two principal defects were closely related to each other.

The Negative Character of Early Legislation.—One defect of our regulatory scheme prior to the last twenty years was that it concerned itself chiefly with provisions intended to keep the railroads within bounds, and to prevent the exploitation of the public through unreasonable transportation charges and arbitrary maladjustments in rate relationships. The principal aim of regulation was to wipe out railroad abuses, and consequently most of the provisions of the legislation took the form of prohibitions. For example, the railroads were warned that they must not discriminate between persons or companies, must not charge more for a short haul than a long haul unless granted specific permission, and must not enter into agreements for the pooling of traffic or earnings. From a positive point of view, not much was said as to what the rates should be. Our legislation did provide, of course, that rates should be "just and reasonable," but no significant meaning was given to these terms prior to the legislation passed in 1920. In short, the early railroad legislation treated in detail the things that the railroads should not do, but paid little or no attention to what they should do if the country was to have an efficient national transportation system. The items which were omitted from the regulation, rather than those which were included, seem to us to constitute the primary purpose of regulation.

The Policy of Enforced Competition.—Though attempts were made, as was stated above, to eliminate some of the worst abuses which sprang up under competition, there was a continued insistence on competition as the condition under which the development of our railroad system should go on. "The anti-pooling clause of the Act to Regulate Commerce, and the prohibitions of the anti-trust laws as judicially applied to the railroads, created serious practical obstacles to the development of responsible relations between the carriers, to the elimination of personal preferences, to the stabilization of competitive conditions, to the achievement of such economies as coordination might render possible, and to the full and flexible utilization of the available plant and equipment. This condemnation of cooperative effort among the carriers through insistence upon the rigorous enforcement of competition, despite the subversive tendencies of such competition in the direction of rate fluctuations and discriminatory practices, and despite the difficulties of maintaining uniform charges among competitors of strikingly unequal strength, was but a reflection of the primary emphasis of the regulatory scheme upon restraining the potential

overreaching of quasi-monopolistic power rather than upon the provision of a satisfactory system of transportation."[2]

The Railroads and the World War.—Because of the nature of our railroad legislation, its application brought results which were, in many respects, undesirable. We spent too much time seeing to it that railroad rates were not unreasonable or discriminatory, and gave too little attention to the question of efficient railroad transportation and to providing the railroads with a rate system which would permit them to earn a sufficient amount to enable them to attract into the industry the capital so necessary for continued efficient operation. Consequently, when the heavy traffic of the World War period began to make unparalleled demands upon our railroads, they were unable to respond adequately. During this great national emergency, the wastefulness of competition in railroading and the importance of having an efficient national system of transportation were fully realized for the first time.

In order to avoid the complete breakdown of our system of railroad transportation which seemed imminent, the federal government undertook to operate the railroads during the participation of the United States in the World War, and for some time afterward. It was impossible, of course, to revolutionize the railroad industry and transform it instantly from a disorganized and inadequate competitive system into an efficient national organization, but many steps were taken during the period of federal operation which augured well for the future. The railroads were operated "as a national system of transportation, the common and national needs being in all instances held paramount to any actual or supposed corporate advantage."[3] Locomotives and other rolling stock were pooled and used as necessity dictated, without regard to ownership. Shipments of freight were moved to their destinations by the most direct routes regardless of the wishes of shippers as to routes or the amount of use made of any particular railroad in the process. Certain railroads were compelled to share their terminals with other railroads, and repair shops were used jointly. Cars were loaded heavily and the demurrage rates, or charges for leaving freight in the railroad cars in excess of a reasonable length of time, were increased to speed up car-unloadings. Passenger service was cut down, and consolidated ticket offices were intro-

[2] I. L. Sharfman, *The Interstate Commerce Commission,* New York, Commonwealth Fund, 1931, part I, pp. 79, 80.

[3] *Ibid.,* p. 155.

duced. The purchase of materials and supplies was centralized, new equipment was standardized, expenses for advertising were reduced, and valuable uniform statistics were compiled.

Whatever conclusion may be reached as to the financial or operating success of the federal control of the railroads, we may at least be thankful for the new attitude toward the railroads which prevailed after the war. When the question of the terms upon which the railroads should be turned back to their private owners was being considered, many different plans were evolved, and yet they all agreed more or less completely in one particular. This was that the growing transportation needs of the country demanded, through some method or other, the welding together of the many independent railroads, each formerly following its own self-interest, into an efficient national system of transportation. It appeared that only by some plan of consolidation or cooperation could economies in operation be achieved, and the railroad plant and equipment be efficiently utilized, while difficulties of rate regulation were being overcome.

The Transportation Act of 1920

The attitude toward the railroads described above received its first legislative expression in the Transportation Act of 1920. Under this legislation, the control of the railroads subject to the provisions of law was continued in the hands of the Interstate Commerce Commission, the agency set up for that purpose in 1887 by the Act to Regulate Commerce. The Interstate Commerce Commission is made up of nine members, appointed for terms of seven years each by the President of the United States with the consent of the Senate. The work of the Commission is expedited by the provision that it may organize itself into as many divisions, of not fewer than three members each, as may be necessary to handle its business, and that each division may act independently of the others, with its decisions subject to reconsideration by the Commission as a whole. The Act of 1920 placed upon the Interstate Commerce Commission some new responsibilities which were expected to be of great import in connection with the solution of the railroad problem. We shall consider the provisions of the law and their operation under four headings—railroad consolidation, rates, securities, and service.

Railroad Consolidation.—In the first place, the Act of 1920 was noteworthy in that the traditional emphasis on competition

in the railroad industry was discontinued. The Interstate Commerce Commission was ordered to prepare and adopt a plan for the consolidation of the many railroads of the United States into a limited number of systems. In drawing up such a plan, the Commission was asked to bear two considerations in mind: (1) To preserve as far as possible the existing conditions and channels of trade, and (2) to make each system such a combination of weak and strong roads that, when uniform rates are applied throughout the country, each system will make substantially the same rate of return upon the value of its property devoted to the transportation service as that made by the other railroad systems. Under the consolidation plan (whenever formulated by the Commission), it was made lawful for two or more railroads to consolidate their properties for ownership, management, and operation, subject to two conditions: (1) The Commission must approve the proposed consolidation as being in line with its final consolidation plan, and (2) the par value of the bonds and stocks of the new consolidation must not exceed the value of the consolidated properties as determined by the Commission.

As a temporary expedient, pending the adoption of the final consolidation plan, it was provided that the Commission could permit one railroad to acquire control of another railroad or other railroads, by means of leases, stock purchases, or any method not involving actual consolidation. In addition, while agreements for the pooling of freight or net earnings were still held to be unlawful in and of themselves, it was provided as another temporary expedient that the Interstate Commerce Commission could approve such agreements and render them valid, or even go to the length of taking the initiative in bring them about.

The Benefits of Consolidation.—The benefits, from a social or national point of view, which might be expected to result from the consolidation of the railroads of the country into a limited number of systems as provided in the Act of 1920, are familiar ones. First, they would make it possible to realize important economies in operation and to utilize to the maximum the existing plant and equipment of the railroads, by methods similar to those employed by the federal government during its operation of the roads. These methods would include, of course, the pooling of locomotives and cars and their use anywhere in the system, the joint use of terminals and other facilities, heavy loading of cars, centralized purchases, standardized equipment, and uniform statis-

tics. In the second place, the consolidation plan would replace numerous existing lines, of varying financial condition and command over traffic, with a small number of systems of approximately equal strength. As a result, rate regulation would be facilitated.

Rate Provisions of the Act of 1920.—Congress, in drawing up the Transportation Act of 1920, was mindful of the necessity for adequate earnings in railroading and tried to make provision in the Act for rates which would make such earnings possible. The Commission was given the power to establish both maximum and minimum rates and, by fixing both, to decide upon the actual rates. Furthermore, it was made the duty of the Commission to exercise its rate-making powers in such a way that the railroads as a whole, or as a whole in such rate groups or territories as it might designate, would earn an aggregate annual net railway operating income equal, or as nearly equal as might be, to a fair return upon the aggregate value of the property of such railroads used in the transportation service. The valuation of the railroad property and the determination of what constituted a "fair rate of return" upon such property, were to be in the hands of the Commission. In determining such fair rate of return, the Commission was to bear in mind the transportation needs of the country and the necessity of expanding railroad facilities, if adequate transportation was to be furnished. It will be noted that no provision whatsoever was made for individual railroads to earn a fair rate of return. It was only for the railroads as a whole, or in certain groups as designated by the Commission, that fair returns were to be sought. The word "group" in this connection may, we believe, be taken to mean a group of railroads somewhat larger than one of the limited number of systems into which the railroads of the country were to be consolidated.

The Recapture Clause.—It was realized, of course, that rates high enough to give a fair rate of return for the railroads as a whole or in large groups would furnish some strong roads enjoying good location and excellent physical condition the chance to make an excessive rate of return. The "recapture clause" in the Act of 1920 was intended to provide against this contingency. According to the provisions of this clause, any railroad which received in any year a net railway operating income of more than 6 per cent on the value of its property devoted to transportation was required to share the excess above 6 per cent with

the government. One-half of the excess income was to be turned over to the Commission for the purpose of setting up what was called a "general railroad contingent fund," while the other half was to be held in a reserve fund by the railroad. When the amount in this reserve fund equaled 5 per cent of the value of the railroad's property, the fund could be drawn upon only to meet fixed charges and make dividend payments in years when its net operating income fell short of the 6-per-cent level prescribed by law. The general railroad contingent fund, on the other hand, was to be used by the Commission to make loans at 6 per cent interest to needy railroads, for the purpose of developing equipment or refunding maturing obligations, or to buy railroad equipment and lease it to the railroads.

Railroad Securities Under the Transportation Act of 1920.—A third division of the Act of 1920 concerned itself with the control of railroad securities. The principal purpose of such control was to make sure that the financial operations of the railroads in the future would be of such a nature as to provide a sound basis for the rehabilitation of railroad credit and for the development of the railroad system. In addition, it was desired to protect the investing public against loss through extravagant and even dishonest financing, such as had taken place at times in the past. The principal provision of the Act, with respect to securities, was to make it unlawful for railroads to issue their own securities or to assume any obligations in connection with the securities of other railroads unless, after their application to the Commission and after investigation by the Commission of the purposes and uses of the proposed financial operation, the Commission should give its consent. The Commission was given rather wide discretionary power in deciding these financial matters, but it was asked to bear two considerations in mind: (1) The proposed transaction must be for some lawful purpose within the business of the railroad, and (2) it must be reasonably necessary and appropriate for this purpose.

Service Regulation.—The fourth major problem touched upon by the Act of 1920 was that of adequate railroad service. Each railroad was ordered to furnish safe and adequate car service, and to set up and enforce reasonable rules and practices with regard to such service. Car service was taken to include the supply and use of rolling stock, the supply of trains, and interrailroad relationships with regard to rolling stock. The Commission was

also empowered, when it considered such action desirable, to formulate reasonable rules and regulations to govern the railroad car service. In case of emergency, the Commission could abolish all existing regulations with regard to car service, and proceed (without regard to the desires of any particular railroads) to provide for the unified utilization of railroad facilities, for the joint use of terminals, for preference or priority for certain commodities in transportation, and for direct routing and expeditious handling of traffic.

Finally, the approval of the Commission had to be obtained before an existing railroad enterprise, or any part of it, could be abandoned, or any new construction of railroads undertaken. Furthermore, in this connection, the Commission was again given power to take the initiative, and order a railroad to provide itself with safe and adequate facilities for carrying on its car service, or to extend its lines by means of new construction.

The Railroads in the Great Depression

Progress Toward Consolidation.—Though the Transportation Act of 1920 represented a refreshing and desirable change of attitude toward the railroad problem, it did not furnish a satisfactory basis for the operation of the railroads in the years after its passage. In the first place, comparatively little progress has been made toward the consolidation of the railroads. It is true, of course, that the Commission in 1921 published a tentative plan which provided for the consolidation of the railroads of the country into nineteen systems. One system was to provide for the needs of New England, five were to be trunk-line systems between New York and Chicago, and five were to be transcontinental systems from Chicago to the Pacific coast. The lower Michigan peninsula was to have one system, and there were to be two "soft coal" lines from the Chesapeake Bay to the Great Lakes. Finally, there were to be three systems in the Southeast and two in the Southwest. Extended hearings were conducted to consider the plan, but little has been done toward putting it into operation. However, several railroads have been allowed to carry out plans for consolidation with other roads or for the acquisition of control over them as provided in the law.

It must be remembered that consolidation is to be voluntary on the part of the railroads, and cannot be forced upon them by the Commission under the present law. Consequently, there are

some reasons for thinking that consolidation will not go forward at a very rapid pace. In the first place, the strong railroads, which are in good physical condition and have undoubted earning power, may not be willing to join forces with the weaker roads to form the systems called for by the consolidation plan, or at least would agree to go into such consolidations only upon terms rather unfavorable to the weak roads. In addition, the railroad officials who would naturally carry on the negotiations for consolidation may not be anxious to do so because of a fear that in the new system they might be forced to accept positions inferior to those which they now hold.

The Control of Railroad Securities and Service.—The provisions of the Transportation Act relative to railroad securities and service have not been of great practical importance up to the present time. Since 1920, and especially since 1929, railroad earnings have been so low that railroad credit has not rated so high as in former times. The carriers have consequently experienced considerable difficulty in refunding their maturing obligations on satisfactory terms, and new issues, for many roads, have been practically out of the question. The control of railroad service by the Commission has been a source of irritation to railroad executives. They complain of the situation as one in which a company cannot extend its facilities if business is profitable, or abandon production if business results in large net losses, without the approval of a governmental commission, and in which a company may be asked to share its productive facilities with competing companies. However, it is doubtful that the Commission's control over railroad service has ever been genuinely effective.

Railroad Earnings Since 1920.—The most serious criticism of the Transportation Act of 1920 is that under its operation railroad earnings were never satisfactory and sank to a very low level after 1929. Apparently many people thought that the Act had disposed of the problem of adequate railroad earnings for some years to come, but a study of the net operating income of the railroads since 1920 discloses that such was decidedly not the case. The rate of net operating income of the Class I railroads in the United States, based upon the aggregate value of their property devoted to the transportation service from 1921 to 1938, is shown in Table 26. It should be noted that the percentages there presented are for the Class I railroads as a whole, and that they are calculated upon the valuations which the railroads

TABLE 26.—THE RATE OF RETURN EARNED BY CLASS I RAILROADS, AS A WHOLE, UPON THE AGGREGATE VALUE OF THEIR PROPERTY DEVOTED TO THE TRANSPORTATION SERVICE, 1921–1938[a]

1921	2 87%	1930	3 30%
1922	3 59%	1931	2.00%
1923	4 33%	1932	1.25%
1924	4.23%	1933	1.83%
1925	4.74%	1934	1.79%
1926	4.99%	1935	1 93%
1927	4.30%	1936	2.59%
1928	4 65%	1937	2 30%
1929	4.84%	1938 (11 months)	1.34%

[a] Sources: *Statistics of Railways of Class I, 1935*, Washington, Bureau of Railway Economics, 1935; *Statistical Abstract of the United States, 1937*, pp. 370–390, *Chicago Tribune*, December 15, 1938.

themselves put upon their properties. If calculated on the basis of the Commission's valuations of the railroad properties they would be slightly higher, because the latter valuations have ordinarily been somewhat more conservative than those of the railroads themselves.

While it is difficult to say just what rate of return upon the aggregate value of railroad properties would be adequate, and no more than adequate, for the maintenance of an efficient transportation system, we may at least point out that the rates actually earned by the railroads since 1920 have been consistently below the rate determined upon by the Commission as one which it considered adequate and reasonable. The Commission decided in 1922 that, for the railroads as a whole, a rate of 5¾ per cent upon the aggregate value of the railroad properties used in the transportation service would be adequate; and it will be remembered that under the Act of 1920 the "recapture" of the earnings of individual railroads was to begin at 6 per cent. If the Commission's figure of 5¾ per cent is accepted as satisfactory for the railroads of the country as a whole, it is clear that the railroads, even in the relatively good period of business between 1921 and 1929, did not earn an adequate rate of return in any year.

Railroad Finances in the Depression.—In the post-1929 depression, with its sharp decline in the volume of goods requiring transportation by any agency, the railroads were very hard hit. The net earnings of Class I railroads fell from 4.84 per cent on the aggregate value of their property in 1929 to the ridiculously low figure of 1.25 per cent in 1932, had risen by 1936 to 2 59 per cent, but suffered a fresh decline in 1937 and 1938. It should

be noted, moreover, that these figures are for net operating income *before the payment of interest charges.* After paying interest charges, the Class I railroads had net deficits in nearly all recent years.

The number of passengers carried by these roads, which had averaged 1,114,055,000 annually from 1916 to 1920, declined to 432,980,000 in 1933, while the revenue freight carried, which had averaged some 427,234,000,000 ton-miles from 1926 to 1930, fell to 233,977,000,000 ton-miles in 1932.[4] Railroads have failed in large numbers in recent years. By the end of 1937, ninety-six railroads, with 71,386 miles of line, had gone into bankruptcy, and were operating under the supervision of the courts. Heavier casualties would probably have occurred had it not been for the activities of the Reconstruction Finance Corporation and the Public Works Administration, in lending some $738,101,000 to the roads. Of this sum, $224,839,000 had been repaid by the end of 1937.[5]

The Causes of the Railroad Problem

The Attitude of Railroad Officials.—While the desperate situation of the railroads in recent years is largely chargeable to the depression, several factors operated to put the industry in a vulnerable position. One was the attitude of railroad officials toward their own business and other forms of transportation. Some years ago, when the railroads provided the only satisfactory means of long-distance transportation, they could count upon carrying most of the passenger and freight traffic of the country. In other words, the demand for their service was inelastic. Under this condition of demand, high rates for passenger and freight tended to yield better financial returns than low rates, and a rate increase could usually be depended upon to increase railroad earnings, if additional income was necessary.

But in recent years motor vehicles, and to some extent the airplane, have developed into efficient and satisfactory agencies of transportation. Consequently, the country is no longer absolutely dependent upon the railroads, and can take their service or leave it, depending upon the comparative rates and service of the railroads and other transportation agencies. Hence, the demand for railroad service is now relatively elastic. Under this

[4] *Statistical Abstract of the United States, 1935,* pp. 368-375.
[5] *Railway Age,* January 1, 1938.

condition of demand, high rates may prove financially disastrous to the railroads, while low rates may bring increased business and improved net earnings.

It would seem that many railroad executives failed to recognize the changes that had taken place in transportation, and continued to think of the service provided by railroads as absolutely essential. In 1931, when railroad traffic and earnings were declining rapidly, the railroads petitioned the Interstate Commerce Commission for increases in freight rates to bolster up their declining earnings. After much discussion and argument, the roads were granted conditional increases in the rates applying to specified commodities, though a change in the opposite direction would probably have had a more salutary effect. Similarly, in 1936, many of the eastern railroads vigorously opposed the decision of the Commission to reduce railroad passenger fares in the hope of increasing traffic and earnings. The conservatism of railroad officials also manifested itself in their reluctance to adopt improvements in railroad equipment and service. Here, again, they acted as though they regarded the demand for railway services as inelastic, instead of elastic as it now is because of the existence of satisfactory substitutes.

The Railroad Labor Situation.—Another factor operating to accentuate the railroad problem was the favorable treatment which the railroads were required by law to afford the workers in the industry. The federal government, in carrying out its policy of railroad regulation, has not hesitated to raise the status of labor in the industry. Railroad gross earnings in 1937 were only slightly greater than in 1916, but railroad wages were much higher. In 1916, the average railroad employee worked 3149 hours for an income of $886, or 27.5 cents an hour. In 1937, the average employee worked 2499 hours for $1764, or 70.6 cents an hour. Hence, the average employee worked 20 per cent less time in 1937 than in 1916, but received wages amounting to 99 per cent more. The total wage bill of the railroads was 31 per cent greater in 1937 than in 1916, while the number of employees was about 34 per cent smaller.[6]

The railroads are compelled by law to maintain safety appliances for the protection of their workers, and the employees, of course, receive free transportation from the roads for which

[6] *Railway Age*, January 1, 1938, and *Statistical Abstract of the United States, 1937*, pp. 370-390.

they work. Bills have been introduced into Congress providing the future payment of the same wages for six hours' work a day as are now being paid for eight hours, and for a dismissal compensation for employees affected by abandonments or unifications of railroads. While these advantages may not be greater than the railway employees should enjoy, they have unquestionably constituted a heavy burden upon the industry in times of depression. On this account, a general 10 per cent reduction in railway wages was permitted, and became effective on February 1, 1932. However, the 1931 level of wages was completely restored by April 1, 1936.

A Defect in Rate Regulation.—It appears to many that the principle of rate regulation set up in the Transportation Act of 1920 was defective in that it provided for the recapture of so-called excess earnings of the individual railroads. If the railroads of the United States are to make a fair rate of return (say, 5¾ per cent) on the aggregate value of their property over a period of years, it will be necessary for them to make much more than that rate in some years, since they certainly will make much less than a fair rate of return in others. It was possible, of course, for individual railroads to obtain a higher rate than 5¾ per cent in certain years, by sharing the return in excess of 6 per cent with the government; but the rates which the railroads as a whole could charge for their services appeared to be adjusted in such a way that no more than the prescribed fair return would be earned by them as a whole in any year, while in some years the rate of return was certain to be less than that established by the Commission. If the 5¾ per cent rate of return is to be significant, it must be interpreted as a long-run rate, that is, one which will tend to be realized over a period of years; and under this interpretation the railroad charges for freight and passenger service and other conditions of transportation should be regulated by the Commission, so that more than 5¾ per cent may be earned in good years to offset the smaller returns of bad years. Otherwise, railroad credit and even the physical condition of the railroads seem certain to be further impaired.

Competition in Transportation.—Probably the principal factor giving rise to the railroad problem was the loss of passenger and freight traffic to automobile and water carriers, both before and during the post-1929 depression. After many years and much legislation of the trial and error variety, we eventually arrived

at the significant conclusion that consolidation and cooperation of railroad lines are preferable to their competition as a means of effecting efficiency and economy in railroading. However, we have been slow to realize that it is equally likely that coordination and cooperation of the several types of carriers—rail, water, motor, and air—would be better than competition, from the point of view of developing an adequate and efficient national system of transportation.

Of course, not all of the railroad traffic losses were due to the competition of other types of carriers. Moreover, the railroads have no legitimate grievance in connection with the loss of traffic to other types of carriers, so long as the traffic gains of these carriers are based on superior service, more efficient operation, and lower costs. But the railroads have often charged that traffic has been taken from them by unfair competition. Into this question, we must look a little further.

Water Competition.—There can be no doubt that there is a place for water carriers in our transportation system, but the railroads have complained that much of the traffic handled by water carriers was secured on the basis of costs that were low only because of special advantages and favored treatment received by these carriers—treatment not accorded the railroads. In other words, it is contended that the competition furnished by some water carriers is essentially unfair to the railroads.

Certain inland waterways have been constructed at heavy cost to the federal government, and have proceeded to charge shippers rates so low that the receipts would barely cover the operating expenses of these water lines. When this sort of thing takes place, the shippers, of course, are not paying the full costs of transportation, but are being subsidized because the taxpayers assume the expenses for fixed charges and maintenance. The railroads, on the other hand, must maintain tracks, bridges, and terminals, and pay their own fixed charges and taxes. Thus, they not only lose traffic to these waterways, but pay heavy taxes as well, part of which go to the support of the waterways, their competitors. Incidentally, the taxes paid by Class I railroads in 1937 amounted to $336,000,000, or about 57 per cent of their net operating income of $590,000,000, before paying interest charges.[7]

To take an extreme example, let us consider the Mississippi-

[7] *Railway Age,* January 1, 1938.

Warrior Rivers Barge Line. It has been estimated that some 600 million dollars were expended by the government on this system and its branches Since its construction as a war project, this barge line had carried, up to 1929, some 7¾ million tons of freight at an average annual loss, borne by the taxpayers, of $440,000; and this figure does not include any allowance for ordinary interest, taxes, and depreciation, such as a private transportation enterprise would have to meet.[8] Not all water carriers, of course, can be compared with the Mississippi-Warrior Rivers Barge Line; but it is probable that a considerable portion of the freight carried by water lines, amounting annually to hundreds of millions of tons, is carried at rates insufficient to cover costs of production, if interest, maintenance expenses, and the taxes which would be collected from strictly private transportation agencies, were included in costs of production. This situation is clearly a cause for concern to the railroads.

Motor Competition.—The competition of carriers by motor has been an even greater thorn in the flesh than that of water carriers. Not only do large numbers of people transport themselves from place to place by automobile, but common carriers by bus have also made a hole in the passenger traffic receipts of the railroads. In addition, tremendous quantities of freight are now being carried by truck, both for short and long distances. Some of the trucks operate as common carriers, that is, they run over regular routes at certain specified times and serve all comers; while others operate as contract carriers, furnishing each bit of transportation service on the basis of a separate agreement as to conditions of transportation, including rates, between the trucking company and the customer. Finally, some companies, engaged in other lines of business, do their own trucking.

The Advantages of Motor Carriers.—Again, the railroads had no thought of contending that there is no place in our transportation system for carriers by motor, but they claimed that much of the competition furnished by these carriers was unfair to the railroads so long as the motor carriers were unregulated as to rates and other conditions of service, and enjoyed special advantages that were not available to the railroads in furnishing their transportation service. First, with regard to the alleged advantages enjoyed by motor carriers, it was pointed out that they

[8] E. E. Loomis, "Railways *vs.* Waterways," in *Review of Reviews*, February, 1929, pp. 79-82.

are largely exempt from certain types of expenses which the railroads have to bear. The roadbed for the motor carriers is the public highway, constructed and maintained at public expense, and the fixed charges on the investment in these highways are not paid by these carriers.

It was recently estimated that truck operators pay, on the average, only 3.6 per cent, and buses only 7.23 per cent of their gross earnings in taxes, which of course includes their only contribution toward the maintenance of, and fixed charges on, the investment in their roadbed, the public highways. The Class I railroads of the country in 1935 paid 6.6 per cent of their gross income for taxes alone; and if the expenses of maintaining roadways and interest on the investment in roadway were included, the percentage would be much higher. For example, it was estimated that the Reading Company found it necessary, in a given year, to pay out 26.46 per cent of its gross operating revenues for taxes, interest on investment in roadway, and maintenance of roadway.[9] Even if interest on the investment in roadway were not included, on the ground that rights-of-way, extra land, and in some cases money were given to the railroads by the various governmental units many years ago, the figure would still have been 15.46 per cent for the Reading Company. If this figure is even fairly typical of the railroads of the country as a whole, it is small wonder that carriers by motor have been able to offer services for passengers and some kinds of freight at rates well below those which the railroads have had to charge.

The Lack of Motor Carrier Regulation.—In the second place, the railroads complained that the motor carriers were almost completely unregulated. Given the advantages outlined above, these carriers were left relatively free to charge any prices they liked for their services, while the railroads could make no changes in their rates to meet motor competition. Changes in railroad rates could be made, of course, but only slowly and with the consent of the Interstate Commerce Commission, and consequently the rates could not be made flexible enough to meet the rapid changes in rates open to the unregulated motor carriers. A truck owner could take a load a certain distance at a remunerative rate and, rather than return with an empty truck, could afford to pick up a return load at almost any price obtainable. He could

[9] Agnew T. Dice, President of the Reading Company, in an address before the Atlantic States Shippers' Advisory Board, at Philadelphia, October 2, 1931.

charge Jones one rate, Brown another, and Johnson a third, for exactly the same service. He could charge more for a short than a long haul, and was subject to almost no restrictions as to adequacy or regularity of service, being permitted to enter or quit the business at will. None of these advantages have been enjoyed by the railroads. To have permitted competition between motor carriers and the railroads to continue on the terms described above would have been to sanction a condition which was fraught with danger for the railroad industry, and to make it extremely unlikely that the railroads, being closely regulated, could earn a return adequate to insure continuous, efficient transportation service.

Solving the Railroad Problem

The Federal Railroad Coordinator.—As a result of the depression and the other factors affecting the railroad problem, the railroad industry was in a woeful condition when the Roosevelt administration took office in March, 1933. This administration, however, lost no time in trying to assist the railroads. It was thought that part of the railroads' difficulty in obtaining adequate revenue was due to their failure to effect the economies which had been expected to accompany consolidation. As we have seen, consolidation had moved at a snail's pace since 1920, and the independent railroads did not cooperate in such a way as to reap any considerable part of the benefits which were expected to result from consolidation. Therefore, in 1933, a law was passed creating the office of Federal Coordinator of Railroads, which office was filled by Joseph B. Eastman, former member of the Interstate Commerce Commission. The duties of the Coordinator were (1) to encourage and promote, or require, the elimination of unnecessary duplication and waste, and (2) to recommend further legislation for the improvement of transportation conditions. Though the Coordinator was continued in office until 1936, his work was hampered by the hostility of the railroad executives.

The Motor Carrier Act.—Another accomplishment of recent years was the passage in 1935 of an Act to regulate motor carriers. The Act was to go into effect on October 1, 1935, but the operation of any part of it could be postponed by the Interstate Commerce Commission, and so the Act did not actually become operative until several months of 1936 had elapsed. While this legislation was not intended primarily to protect other forms of transportation, but rather to improve and stabilize conditions in

the motor carrier industry itself, the competition of motor carriers has affected the railroads so seriously in the past that we may well consider briefly the provisions of the Motor Carrier Act.

Provisions of the Act.—The law applies to common carriers, contract carriers, and brokers, engaged in interstate commerce by motor vehicles, but not to private carriers, except possibly with respect to safety regulations. The Act gives the Interstate Commerce Commission authority to prescribe rules governing employees, hours of service, and standards of equipment in the motor carrier industry. The numerous exceptions to the application of the law include school buses; taxis; hotel buses; motor vehicles operated by the Department of the Interior in the National Park service; motor vehicles used by farmers; motor vehicles of cooperative agricultural associations; trolley buses operated by electric power; motor vehicles carrying livestock, fish, and agricultural commodities exclusively; motor vehicles carrying newspapers exclusively; transportation within municipalities and adjacent areas; and casual, occasional or reciprocal transportation by a person not engaged in transportation as a business.

Common carriers must secure certificates of public convenience and necessity, and must show the need for their service and their willingness and ability to perform it. Their business may include movements between fixed terminals and over regular routes, and only such business, but equipment and facilities may be added freely. Contract carriers must secure permits to operate, and must show the need for their service, their ability to perform it, the nature of the goods to be transported, and the territory to be served. They do not operate between fixed terminals, or over regular routes. Brokers, or persons other than carriers and their agents who sell transportation which is subject to the Act, must secure licenses, and show the need for their service and their ability to perform it. Common carriers already in operation on June 1, 1935, contract carriers in operation on July 1, and brokers in business on October 1, were allowed to secure certificates, permits, or licenses without further proof by making proper application before the last available date as fixed by the Commission.

Common carriers must file rates and abide by them, subject to heavy fines for transporting without filing rates or for charging rates other than those on file. The rates must be reasonable and non-discriminatory, and may be changed only upon thirty days' notice to the Commission and the public. Contract carriers need

file and publish only minimum rates. They may charge more than these rates, but changes in the minimum rates require thirty days' notice. The Commission does not have authority to prescribe the original rates for the motor carriers, but upon complaint or on its own initiative it may suspend and investigate any rates except the original ones. It may investigate the lawfulness of the rates on file and if, after holding hearings, it finds that rates do not comply with the law, it may prescribe new rates.

For purposes of enforcement, a division of four members of the Commission was created to supervise all matters pertaining to motor vehicles. Under this division, a motor carrier bureau was established with district offices in various parts of the country. Violations of the law are subject to a $500 fine for a first offense, and $2000 fine for each additional offense. These penalties apply to both shippers and carriers. The common carriers must give bills of lading for goods transported, and the carrier which first handles a shipment is responsible to the shipper for any loss, damage, or injury caused by it or any other carrier, but the first carrier has a claim upon a subsequent carrier if the fault lies with the latter. The Commission controls security issues, consolidations, mergers, and acquisitions of control in the industry, and may recommend additional legislation. It is also authorized to investigate and report on the need for regulations as to the size and weight of motor vehicles.

A Preliminary Estimate of the Law.—It is too soon as yet to pass judgment upon this attempt to regulate motor transportation. At the very outset of the operation of the law there was considerable confusion. Motor carriers filed tariffs, and then requested immediate changes. In some cases they failed to collect the published rates and fares, and did not make their tariffs available for public inspection. Sometimes the rates announced by carriers differed considerably from those announced by their authorized agents, and the carriers complained grievously about one another. It is clear that there are considerable practical difficulties to be overcome in enforcing this law, because there are so many operators and because the business of many motor carriers is by no means so regular, well established, and easy to supervise as that of the railroads. If shippers cooperate whole-heartedly with the Commission, and if appropriate penalties are imposed upon violating shippers and carriers, the law may operate successfully If the Act can be administered with reasonable efficiency, it will go

far toward stabilizing conditions in the motor transportation industry, eliminating cutthroat competition between motor carriers and railroads, and laying the foundation for the sound future development and coordination of these two branches of transportation.

The Recapture Clause.—In 1933, the recapture provision of the Transportation Act of 1920 was repealed. This clause, it will be remembered, required individual railroads to turn over to the government one-half of their net operating income in excess of 6 per cent, on the value of their properties devoted to transportation, and to place the remainder of such excess earnings in a reserve fund. The recapture clause had been a source of great annoyance to the railroads, though it probably was not a serious financial burden in view of the generally low railroad earnings since 1920. The clause seems to be inconsistent with the declared principle of allowing the railroads to earn a fair return upon a fair valuation of their transportation properties, and we believe its repeal should be permanent.

Improvements in Railroading.—In the past few years, the railroads have manifested a startlingly progressive attitude toward their business. Some have adopted streamline trains for certain routes, and these trains are said to have both increased the speed and convenience of the service and lowered the operating costs. Many roads have installed air-conditioned passenger cars, and made other changes in equipment which have increased the comfort and convenience of railroad travel. Many have also inaugurated what is called a store-door pick-up and delivery service, to make the railroad freight service comparable to that furnished by motor carriers, and have in some cases begun to operate their own trucks and buses. Such a wide-awake attitude on the part of the railroads is likely to be much more conducive to a solution of their problem than their former "standpat" attitude.

Passenger Rates.—The Interstate Commerce Commission, through its control of both maximum and minimum railway rates, holds the power to decide what passenger and freight charges are to prevail. In 1936, the Commission decided to investigate the effects of reduced passenger rates. It ruled that the basic passenger fare should be changed from 3.6 cents to 2 cents a mile in coaches, and to 3 cents in Pullman cars; and also eliminated the 50-per-cent surcharge on Pullman service. It was hoped that these reductions would bring an increase in passenger traffic which would more

than offset the lower fares, and thus yield the roads a greater net income from passenger traffic. The results of this experiment cannot be stated with definiteness Railroad passenger traffic picked up sharply under the low rates, but before the full effects of the reduced charges could be thoroughly tested, the business recession of 1937-38 brought an upset to all calculations. In July, 1938, the Interstate Commerce Commission permitted the railroads east of Chicago to raise the basic passenger fare from 2 to 2½ cents a mile, and these roads promptly made the change. This ruling of the Commission would seem to suggest that the rate reduction of 1936, though sound in principle, may have been too great in size.

Freight Rates.—With earnings in the early part of 1938 running far below those of the previous year, the railroads appealed to the Interstate Commerce Commission for a 15-per-cent increase in freight rates. In March, 1938, the Commission granted what was called a 10-per-cent increase, but there were so many exceptions that the increase amounted to only about 5 per cent throughout the entire rate structure. The roads are expected to derive about $270,000,000 in additional revenue through this increase, but the actual effects are a matter which the future must decide. The railroads may lose so much traffic to other agencies of transportation that this loss will more than offset the increase in rates. The railroads contend that the extra revenue, if actually realized, will merely cover recent increases in costs of production, and will not in reality better their financial condition. Later in 1938, the roads requested a further "emergency" increase of 5 per cent in freight rates.

Railroad Wages.—In May, 1938, the railroads decided to reduce the wages of their employees by 15 per cent, effective July 1, 1938, but later changed this date to December 1, 1938. Declining revenues and increased expenses of operation had combined to make the railroad situation even more serious than in 1932, and the roads determined upon a wage cut in the hope of saving some $250,000,000 annually. The leaders of the railroad labor unions immediately announced that the cut would be resisted. No agreement could be reached through direct negotiation between labor and management, and the services of the National Mediation Board were requested in August, 1938. The Board was unable to mediate the dispute. The President then appointed a fact-finding committee to report on the problem. The decision of this com-

mission was not binding on either labor or management, and for a time it appeared likely that there would be a strike; but in November, 1938, the railroad executives decided to withdraw the proposed wage cut. It seems, however, that this problem may have to be faced soon again.

Railroad Consolidation.—Though some of these measures may aid in providing temporary relief for the railroads, it appears evident that, so long as the roads consist of a large number of independent lines, they will fail to enjoy many economies which might be theirs through consolidation. Efforts to induce the railroads to consolidate voluntarily, but according to a general plan evolved by the Interstate Commerce Commission, have met with but little success. As an alternative, it has been proposed that we have compulsory consolidation of the railroads. Some people would give the Commission the power, after mature deliberation and extended hearings on the subject, to effect such consolidations as might appear desirable from the point of view of securing efficient railroad operation. In some instances, these consolidations would probably appear to be contrary to the corporate interests of individual railroads, but it is argued that the private interests of a few railroads should be subordinated to the interests of the country as a whole in developing a sound national transportation system. It is said to be, after all, only a step from the Commission's present authority to control the extension of railroad lines and services to the power to order the consolidation of certain railroad properties. Moreover, it is argued that the railroads themselves would probably prefer compulsory consolidation to governmental ownership and operation, which might be seriously considered if efficiency in transportation cannot be achieved under regulation. However, compulsory consolidation should probably not be attempted unless we are willing to turn to government ownership in case the railroads refuse to cooperate. In the meantime, it might be desirable to try to bring about consolidation by relaxing the former requirement that such consolidation must conform to a general plan set up by the Commission. For example, the railroads might be allowed to consolidate as they see fit, subject to the approval of the Commission.

The Regulation of Transportation by Water.—Although much may be accomplished by the new legislation for regulating motor carriers, we must also face the fact that water carriers still remain quite largely outside the field of regulation. The Interstate

Commerce Commission has at present limited control over carriers by water by virtue of its control of the railroads. That is, where joint rail and water routes are used, and in cases where railroads are allowed to own water carriers, the Commission has jurisdiction. Other control over water transportation, such as that over Great Lakes carriers and those in the coastwise trade, was vested by an Act of 1916 in a separate organization called the Shipping Board. This control, however, does not apply to rates in anything like so great a degree as the control of the Interstate Commerce Commission over railroad rates, and it should be extended. Moreover, the question of whether certain water carriers charge low rates because they are, in effect, subsidized by the government should be carefully investigated. It is our contention that in the years to come the regulation of water carriers, including the control of rates and service, under present and future legislation, should be intrusted to the Interstate Commerce Commission, in addition to its present duties of regulating the railroads and motor carriers.

The Commission has had a high degree of success in the past in wisely administering legislation which, through most of the life of the Commission, has been notably defective in certain respects. The additional duties proposed here for the Commission might make it necessary for much work of a routine nature to be intrusted to clerical assistants, or for individual commissioners to handle some cases that come up, rather than having them decided by the Commission as a whole or by the larger divisions of the Commission previously mentioned. Nevertheless, the regulation of the transportation system should be centralized in a single agency, for only thus can real coordination be obtained and all types of carriers be adequately protected. The rate adjustments made for any one type of carrier will affect the ability of other types of carriers to earn a fair return on their investment, and it is unthinkable that different agencies should be allowed to make these adjustments for the several types of carriers, if conditions in transportation are ever to be stabilized.

The Recommendations of the Railroads.—There are many changes which railroad executives believe should be made in the regulation of railroads, in addition to the abandonment of the old consolidation plan. Some executives urge the repeal of the Denison Act, which requires railroads, upon order of the Commission, to make joint rail-water rates with the government barge lines, and

turn over traffic to them. Many would like to have a relaxation of the present rate regulations applying to short and long hauls, and the abandonment of Commission control over railroad extensions, acquisitions, and abandonments. Finally, it is sometimes suggested that the Commission's power to suspend railroad rates should be limited to cases in which certain persons or firms can show the prospect of irrecoverable injuries. However, it is doubtful how far we could go by way of relaxing railroad regulation and still avoid the chaotic conditions of the past.

The Case for Governmental Ownership and Operation of the Railroads.—In spite of the promising measures which have been taken in recent years, there are many people who believe that the railroad problem cannot be solved under a system of regulation, and that the federal government should take over and operate the railroads. Indeed, former Coordinator Eastman himself suggested that governmental ownership and operation may eventually be the best solution of our railroad problem. Those who hold this view advance many arguments in its support. In the first place, it is said that under governmental ownership and operation the objective would be efficient transportation and the promotion of the public welfare rather than private profits. It would only be necessary for the railroads to be self-sustaining under governmental operation; and profits, when made, could be used for the benefit of the general public or distributed in advance to railroad users in the form of lower rates, more adequate and safer service, or freedom from labor disputes through the payment of high wages to the railroad employees.

In the second place, it is contended that the management of the railroads would be as efficient under governmental ownership and operation as under private management—if not, indeed, more so. The railroad system, under governmental operation, would realize to the fullest extent those savings to be obtained from unified management—savings such as were realized under governmental operation during and after the World War and which were among the chief objectives in the plan for voluntary consolidation described in this chapter. Moreover, the cost of regulation would no longer exist and a saving in interest charges would be effected, since the federal government can borrow on its own bonds at a lower rate of interest than that charged the railroads as private corporations. As the result of efficient operation and the fact that profits would no longer be necessary, rates could be lowered, and

the centralized control over rates would insure the disappearance of personal and local discriminations.

Incidentally, it is held that the relations of the government to labor in the railroad industry would be more harmonious than those which have prevailed in the past between railroad labor and the railroad corporations, and that losses would no longer be sustained because of the activities of dissatisfied employees. Investors in railroad securities would also be benefited through the substitution of governmental obligations for those of the railroad corporations and the elimination of the question of railroad failures and receiverships. Finally, it is pointed out that the majority of the railroads in the world outside of the United States are owned and operated by governments, and that the trend appears to be in the direction of government ownership, rather than away from it.

The Case for the Continuance of Regulation.—Despite this imposing array of arguments, there is something to be said on the other side of the question. So far as the stated objective in railroad operation is concerned, there is, we believe, a clear case for governmental ownership and operation; but whether this objective would be realized in practice depends upon a number of other considerations, not the least of which is the efficiency of management under governmental operation. Even if we grant for the moment an efficiency of management under governmental operation comparable to that under private operation, is it likely that any great gain would be realized from the fact that the profit motive would no longer predominate? So far as the past is concerned, it is certain that the welfare of the people of this country would not have been greatly enhanced by the capture and devotion to public purposes of the profits made by the railroads since 1920. The total investment in the Class I railroads of this country amounted in 1930 to over 26 billion dollars. While the government would probably take over the railroads at something less than the railroads' own valuation of their property, it is probable that over 20 billion dollars' worth of government bonds would have to be issued for the purchase of the railroads. The railroads now have to pay fixed charges only on their bonds, since income to the stockholders is contingent upon net earnings, while under government ownership the total investment in the railroads would be represented by bonds upon which fixed charges would have to be met. On the other hand, the rate of interest would be less upon these

obligations than upon those of the railroads. The probable result would be, then, that the fixed charges which the government would have to meet would be in the aggregate somewhat less than the total of fixed charges and dividends which would be paid if the railroads should make the fair rate of return on their investment that was prescribed by the Commission. In other words, a saving could be realized through forsaking the profit motive, if efficiency of management could be maintained.

The question of efficiency of management is crucial. The arguments advanced above, supporting the view that governmental ownership and operation would be efficient, are all sound enough, but they leave out of consideration one very important factor—the human element in management. From a mechanical point of view, the railroads under governmental ownership would be organized in the form which appears most conducive to efficient operation; but what about the managers in charge of railroad operation? It might be difficult to find men of sufficient ability to manage a national railroad system successfully, for the railroad industry as a single unit would make the largest present industrial concern appear as a mere dwarf by comparison. Even if these "super-managers" exist, it is doubtful whether they would be chosen under our governmental system, in which political motives usually appear to control appointments—at least in part. If the right men were found by some method or other, would the government pay salaries high enough to attract them into the railroad service? Finally, if satisfactory managers could be attracted to the railroad industry, it is doubtful whether they would work as hard to hold down a job furnished by the government as one under private control of the railroads where their positions and salaries were dependent upon the results produced for the stockholders. Unless some way could be found to control satisfactorily the personal element in railroad management under government ownership, it appears that adequate service at reasonable rates might more readily be attained under regulated private management.[10]

In connection with the question of efficiency of management, it has been asserted that, if the government had owned and

[10] For a thorough and impartial discussion of this and other points concerning governmental ownership and operation of the railroads, see Eliot Jones, *Principles of Railway Transportation,* New York, The Macmillan Company, 1924, pp. 499-544.

operated the railroads during the years from 1930 to 1935, it would probably have incurred a railroad deficit of $10,000,000,000. The railroads under private management reduced operating expenses sharply during the depression years, while the government probably could not have done so, because of political pressure. In 1933, operating expenses for our railroads were 73 per cent of gross earnings, but operating expenses were 105 per cent of gross earnings in Germany, 107 per cent in Belgium, 112 per cent in Norway, 114 per cent in Denmark, 118 per cent in France, and 119 per cent in Italy.[11] In these foreign countries all or part of the railroads are owned and operated by the government. This inability of governmental railroad management to avoid recurring deficits is said to be a strong argument against governmental ownership and operation, for our private railroads have paid as high wages and have given as efficient and comfortable service as the government-owned railroads, in spite of the excessive operating expenses of the latter.

Again, in the matter of rate discriminations, it does not seem that governmental ownership and operation would help. Personal discriminations have already been eliminated for the most part, and local discriminations might easily continue under government ownership Who would want railroad rates to be adjusted between the different parts of the country by the same method as that which is used in distributing tariff favors? To go a step further, who would want expenditures for the maintenance and improvement of the railroads to be granted to the various districts of the country upon the same basis as that which is now used in passing out appropriations for the improvement of rivers and harbors, and the construction of post offices, court houses, and other public buildings? Political influence in railroading would endanger the efficiency of our transportation system.

From our war-time experience with governmental operation, it seems reasonable to suppose that the government might succeed in establishing more friendly relations with labor than those which exist at present between the railroad corporations and railroad labor; but it is to be feared that the new condition would be brought about through the payment of such high wages that railroad employees would become a favored class, to the prejudice of other members of the community. Finally, it appears that the inter-

[11] *Railway Age,* April 18, 1936, p. 669.

ests of the holders of railroad securities can be as well protected under regulation as under government ownership.

Such are the arguments which are commonly advanced for and against the governmental ownership and operation of the railroads. It is not our function to suggest to the reader the final conclusion to be arrived at out of this welter of opposing arguments, for it is the privilege and duty of a citizen to weigh the evidence pro and con and reach a decision for himself. Indeed, it is important that a decision be reached fairly promptly by our voters, for the matter of governmental ownership and operation of railroads may easily become the question of the hour in the relatively near future.

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1. Why are the railroads important in our present economic system?
2. What is the nature of the "railroad problem"?
3. What is meant by saying that the railroad industry is one of increasing returns? How does the concept of increasing returns differ from that of decreasing costs?
4. Why are railroads said to operate under conditions akin to those of joint costs?
5. Under what condition did the railroad industry operate during the early years of its life in this country? What abuses sprang up in connection with the railroads during this period? Why?
6. In what respects was the early legislation affecting the railroad industry defective? Explain fully.
7. What adjustments in railroad operation were made necessary by the World War? Why?
8. Why does consolidation in the railroad industry appear desirable?
9. What were the provisions of the Transportation Act of 1920 with regard to consolidation? What progress toward consolidation has been made under this law?
10. What were the provisions of this law with respect to railroad rates and earnings? Explain.
11. How did this Act attempt to control the issue of railroad securities and railroad service?
12. What was the fate of the railroads in the depression years of 1929 to 1933?
13. What change has apparently taken place in the nature of the demand for the services of the railroads? How was this change related to the railroad problem?
14. What was the significance of the railroad labor situation in connection with the railroad problem?

15. To what extent was the railroad problem due to the competition of other transportation agencies? Explain.
16. Why was the competition of water and motor carriers often characterized as unfair by the railroads? Were the contentions of the railroads with regard to this competition sound?
17. Summarize the main provisions of the Motor Carrier Act of 1935.
18. Is the Act likely to accomplish the purposes for which it was intended? Explain.
19. What other steps have been taken in recent years to provide relief for the railroads? Explain.
20. What improvements have recently been made in the equipment and operation of the railroad industry?
21. What further steps are essential to the solution of the railroad problem?
22. Why do some people contend that the only real solution of the railroad problem is governmental ownership and operation? Explain.
23. Why are other people quite as firmly convinced that the governmental ownership and operation of the railroads should be avoided, if possible?

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22 PUBLIC UTILITIES

THE RAILROADS, WHICH WERE DISCUSSED IN THE PRECEDING CHAPTER, ARE REGARDED AS PUBLIC UTILITIES BY SOME WRITERS, while others, though admitting that railroads are "public utilities" in many essential respects, prefer to treat them separately. This separation makes for convenience in discussion, for the railroads have been regulated very largely by the federal government, while the control of the public utilities has been carried on almost entirely by the state governments.

THE NATURE OF PUBLIC UTILITIES

Natural Monopolies.—It is not easy to draw up a complete list of public utilities, since the items included under this heading change from time to time. Among the activities which have been classed as public utilities at one time or another, are street railways; water, gas, electric, telephone and telegraph companies; steamship lines; grain elevators; and stockyards—in addition to the railroads. When used in conducting such activities, private property is no longer strictly *private*, because in such uses it becomes "affected with a public interest."

What is it that causes a business to be classed as a public utility? One thing is the possession of the characteristics which make it a "natural monopoly." A natural monopoly is a type of business in which competition usually results in duplication of equipment and great waste. Imagine, for example, the waste which would occur if a city were served by two competing street railway systems, with duplicate tracks throughout the town, and duplicate rolling stock, power lines, and operating personnel. Each of these companies might be confidently expected to have a higher cost of production per unit of service than the cost would be if a single transportation company were operating in this city.

Most public utility businesses require a huge original investment in plant and equipment, and have large fixed or overhead costs. Such businesses enjoy increasing returns as they increase

the volume of business transacted with a given amount of productive facilities, since the additional business increases only operating costs, and not fixed costs, while the total revenues expand considerably. Consequently a public utility company undertakes to get as much business as possible and, when two utilities offer the same service to the same customers, their relations often degenerate into cutthroat and destructive competition. Such a condition, marked by violent rate-cutting, is likely to last until one company is ruined or absorbed by the other, or until the competitors see the light and agree to combine. Even if competition were as economical as monopoly in these businesses, it might still be desirable to have some of them operated as monopolies. In telephone service, for example, it is important, in the interests of convenience, for all telephone users to be subscribers in a single company, rather than to have them distributed among several companies. As a result of these and other considerations, governmental units have come to recognize the need for monopoly in such businesses, and have permitted and even encouraged monopoly operation.

Essential Products.—A second characteristic of public utilities is that their products, whether services or commodities, are generally regarded as vitally necessary to the public. In our large cities, thousands or hundreds of thousands of people look to surface, subway, and elevated railway lines for transportation, and their dependence upon other public utilities, such as electric companies, is so great that a stoppage of service, even for an hour or two, may lead to considerable inconvenience or even to genuine suffering. In the field of communication many individuals and businesses depend largely upon the telephone or telegraph service. In general, the demand for public utility services is inelastic. To be sure, the demand for (say) gas, on the part of some users at least, may be elastic because of the existence of satisfactory substitutes, but the demand for heat, light, or power in some form or other is relatively inelastic.

Franchises.—A third characteristic of public utilities is that many of them are dependent, for the right or power to operate, upon privileges or favors granted them by the public through various governmental units. Street railways, and water, gas, and electric companies, must use public streets or highways, or the areas above or below such streets and highways, in the conduct of their business, and are given grants, or "franchises," by state and local governments for this purpose. Moreover, governments

sometimes grant public utilities the right to condemn private property for necessary purposes or to use public water power in their business.

Differential Rates.—A fourth characteristic of public utilities is that a company, such as one supplying electric current, is sometimes permitted to sell its service to several classes of consumers for different purposes at different prices. It is usually quite impossible to determine the exact cost of supplying the service to any particular class of consumers and, as a result, the rates charged are likely to be arbitrary and to be based upon "what the traffic will bear."

The Regulation of Public Utilities

With public utility businesses operating as monopolies in their particular areas, producing essential economic goods for which the demand is relatively inelastic, and depending in many instances upon special privileges or favors granted by the state, it is clear that the unregulated operation of these businesses by private enterprisers might result in great evils, including extortionate rates for inferior service and unfair discrimination between different consumers or classes of consumers. The possibility of operation of an anti-social nature led to early regulation of public utilities—so early, indeed, that the problems connected with public utilities were almost completely local in character, and their regulation could scarcely have been assumed to fall within the constitutional powers of the federal government. As a result, the regulation of public utilities has been conducted largely by the states.

Public Utilities Commissions.—This regulation has not ordinarily been undertaken directly by state governments. Rather, the regulatory powers have been delegated to commissions. Some of the better-equipped public utility commissions have powers similar to those exercised by the Interstate Commerce Commission in regulating the railroads. They often control rates and fares, extensions and abandonments of service, the issuance of securities, the prevention of discrimination between different customers and classes of customers, the quality of the service, the valuation of utility properties, and accounting methods. Of all these many items, the most difficult and important is, of course, the regulation of rates

The Regulation of Rates.—The states, and their public utilities commissions, were at first left quite free to regulate the rates

charged by public utilities. The courts, including the United States Supreme Court, refused to interfere with what was so obviously an exercise of powers granted to state governments by the Constitution and would neither set aside prescribed rates nor themselves set up rates for the utilities. Eventually, however, the court attitude changed and the Supreme Court decided that if rates set by state governments or their commissions were so unreasonable as practically to destroy the value of the properties of public utilities, they could be set aside as violating the "due process" clause of the federal Constitution. Thereafter, the commissions, while trying to protect the interests of consumers, have been kept from setting public utility rates at so low a figure that they would be confiscatory with respect to the properties of public utilities; and the general idea has developed that rates should be regulated in such a way as to enable the utilities to earn a "fair rate of return on a fair valuation of their properties."

The Problem of Valuation.—It is all very well to say that the utilities should be allowed to earn a fair rate of return on a fair valuation of their properties, but quite another matter to apply the principle to specific cases. The first difficulty is to establish a fair valuation. The property of a public utility scarcely has a value, in the usual economic sense of exchange value, since it is seldom bought and sold and is hedged about with restrictions and regulations which do not affect ordinary property. The value of a piece of industrial property is usually determined by the income it is capable of earning. But in the case of public utilities, earnings depend upon rates and these rates (if they are to represent a "fair return") cannot be set until after the "fair valuation" has been determined. Therefore, the commissions have had to turn to other methods of evaluating the properties of public utilities. The problem of valuation has usually been approached by way of "prudent investment cost" and "reproduction cost."

Prudent Investment Cost.—Prudent investment cost is ordinarily taken to mean the amount of capital actually invested in a public utility enterprise, corrected for capital expenditures dishonestly made or made in a clearly wasteful or extravagant manner. There are several possible ways of arriving at prudent investment cost. It is sometimes said that the par value of the stock of a public utility represents satisfactorily the amount of the actual investment in the business. This criterion, however, could not be applied to all public utilities, since some have issued stock with no

par value. Moreover, there may be only a vague relationship between the par value of a utility's stock and the actual value of its property. Some public utilities are overcapitalized, and have outstanding an amount of stock well in excess of the value of their properties. For example, a public utility company, just starting in business and short of cash, may wish to acquire a piece of property without paying cash for it. To induce the owner to accept stock in lieu of cash, the company may have given him stock which has a par value well above the cash value of the property that is being acquired. Of course, to allow public utilities which are overcapitalized to earn a fair return on their capitalization, would be to grant them an excessive return on the actual value of their property.

Again, the par value of a company's stock may at one time have represented accurately the value of its property, but no longer do so because through poor management the utility has lost some of its original assets or had them depreciate in value. Or the property of a company may increase in value without the increase being reflected in the amount of capital stock outstanding. In either case, a fair rate of return on the basis of capitalization would give a return on the actual value of the property which was either larger or smaller than it should be. Consequently, capitalization has little to recommend it as a basis for valuation.

Another proposal is to assume that the market value of a public utility's stock represents the present value of its property. About all that can be said for this method is that a valuation could be readily obtained by finding the total value of the company's stock on the stock exchange. Such a valuation would be most unsatisfactory, however. The value of the company's stock depends largely upon the rate of return which prospective owners hope to obtain by holding it, and the total value of its stock tends to be its present and probable future rate of earnings, capitalized at the current rate of interest. Since the total value of the stock depends upon the company's earnings, to make the earnings dependent upon the total value of the stock would be to reason in a circle. If a company were at present making an excessive return upon its actual investment, its stock would tend to sell well above par. And if the present value of its stock were taken as its valuation, a fair rate of return on this valuation would permit the continuance of an excessive rate of return upon the actual investment.

Original Cost.—If we were to use prudent investment cost as a method of valuation, it would be necessary to find a satisfactory method of converting the term into action. This might be done, it is often said, by taking prudent investment cost to mean the actual original cost of a public utility's properties, adding the cost of additions and improvements, and deducting any depreciation in the properties or loss of assets. It is argued that such a valuation is eminently fair to all concerned. It grants a public utility a fair return on the capital actually invested in the business, as of the present time, and the utility has no right to claim better treatment. Moreover, it protects consumers from having to pay rates which would give the company a fair rate of return upon an excessive valuation of its properties. Finally, the valuation on the basis of original cost, once ascertained, would not change except when actual changes in investment occurred in the future, and it would provide a stable basis for rate regulation.

But there are some drawbacks to this method of valuation. One is the obvious difficulty of ascertaining original cost. Many public utility properties were acquired long years ago, and records of the transactions may have been lost or destroyed, if indeed they were ever kept. If a company originally acquired property by giving the owner stock instead of cash, should the original cost of the property be construed to be the par value of the stock given, or an estimate of its cash value at the time? Or if, at some time in its career, a company has bought out competitors, either through cash purchase or the exchange of securities, and, in order to be rid of the competitors, paid an excessive price for their properties, should original cost be interpreted to mean the price actually paid or only the construction value of the properties? Should an allowance be made the company for the original cost of promoting the company, of building up good will, and of acquiring a franchise and, if so, how large an allowance? How can we prevent companies from padding their costs, if original costs are used as the basis for valuation? These and other questions suggest that there is considerable room for error in estimating original cost.

Even if it should be possible to ascertain original cost accurately, there is no assurance that this method of valuation would be fair to public utility companies and investors at all times, since it does not take into account changes in the general price level. The original cost method gives a fixed valuation to a public utility company's property, and a fair rate of return on this valuation

means a relatively fixed money income. In a period of falling general prices, this stable money income would give increased purchasing power to the company and its stockholders, and impose a correspondingly heavy burden on the consumers, while in periods of rising prices it would bring decreased purchasing power for company and stockholders, and the consumers would be obtaining public utility services at bargain prices. This objection is not so serious as it sounds, however, for public utility commissions do not guarantee the utilities a stable money income. They merely try to regulate rates so that utilities will *normally* make a fair rate of return on the value of their property. Even if the rates are not reduced in a period of falling prices, the volume of business done at these rates will likely decline to such an extent that a utility's real income will not be enhanced unduly; and if rates are not raised in a period of rising prices, the increased volume of business at these rates may serve to keep the utility's real income from declining severely. However, the long-time upward or downward trends in general prices may serve to affect, either favorably or unfavorably, the purchasing power of the income received by public utility companies.

It is also said that the original cost method of valuation tends to discriminate between the consumers of the services of different utility companies. If one company's plant was constructed and its property acquired at a time when prices and costs were high, its consumers would have to pay rates sufficiently high to give the company a fair return on its high original cost. At the same time, the customers of another utility may be charged much lower rates because this company's plant was constructed and its property acquired at a time when prices and costs were low. Finally, the original cost method, when first introduced, may work a hardship upon persons who have bought the stock of public utility companies because of the high actual earnings of the companies and high returns paid on the stock. When the companies are subsequently limited to earning a fair return on the original cost of their properties, the dividends may be sharply reduced so that the stock will decline in value and deprive the owner of a part of his investment.

Reproduction Cost.—The principal alternative to the use of prudent investment cost for valuation purposes is valuation on the basis of the reproduction cost of public utility properties. In applying this method, the cost of reproducing or replacing a

company's properties is estimated and this figure is adjusted for depreciation, or the supposed difference in value between the actual properties and similar new properties. Of course, if the properties are not allowed to depreciate, an adjustment is not necessary. Valuation on the basis of reproduction cost is a more recent development than valuation on the basis of original cost, and is more flexible and therefore more readily adjustable to changing business conditions. Moreover, it is said to be in stricter conformity with the dictates of economic theory. Since business enterprisers ordinarily plan future production on the basis of prospective prices and prospective costs, rather than upon the basis of costs incurred in past production, it is held to be more logical to evaluate public utility properties for rate-making purposes on the basis of reproduction cost, rather than original cost.

However, it is difficult to get a definite valuation by the method of reproduction cost, for several obstacles stand in the way. Should reproduction cost be taken to mean the cost of constructing identical productive facilities or substitute facilities which would have the same total productivity? Should it be estimated as under present conditions and methods of construction or under methods and conditions which existed when the company's productive facilities were constructed? What would it now cost to acquire the company's franchise or build up the good will which it developed in the past? These questions are more readily asked than answered, and in the absence of satisfactory answers the proper valuation of a company's properties on the basis of reproduction cost is a debatable matter.

The flexibility of valuation on the basis of original cost may be an advantage or a disadvantage. When the general price level falls, the cost of reproduction falls also, so that a lower valuation for a property is appropriate, while the reverse is true in a period of rising prices. Assuming that the rate of return remains unchanged, the money income of the company will decline as the purchasing power of money increases and increase as the purchasing power of money declines, so that the real income of the company and its stockholders should remain fairly constant. In general, a fluctuating money income and stable real income would be preferable to a stable money income and fluctuating real income. However, this adjustability means that the valuation of a company would never remain stable for any great length of time, since it would change with changes in the general price level. As a result,

a company's valuation would be constantly in a state of flux and neither the company nor the regulating commission would have anything definite to go on. The cost of reproduction method is advantageous in that it does not discriminate between the consumers of different utility companies, as does the original cost method; for two substantially similar plants would probably be given approximately the same valuations on the basis of reproduction cost, however different their original cost may have been because they were constructed at different times and under different cost conditions. Furthermore, the use of reproduction cost is likely to cause plants to be built efficiently and at low cost, since original cost will not affect valuation or earnings, while under the original cost method there is an incentive to make the original cost high for valuation purposes.

The Fair Rate of Return.—In addition to deciding, upon some basis or other, the valuations to be placed upon the properties of public utility companies, public utility commissions have to decide upon a fair rate of return on these valuations. This, also, is a difficult matter. The commissions must protect the public against the monopoly powers of public utilities, but at the same time the companies must earn enough to cover costs of production, so that they may render efficient service, maintain their productive facilities, and attract new capital for purposes of expansion and improvements. Moreover, in addition to deciding the rate of return they would like the utilities to earn on the basis of their valuations, the commissions must determine the prices for services which are most likely to produce the desired rate of return for the utilities, keeping in mind the uncertainty of business conditions and possible variations in the cost of producing the services. A given set of prices will produce different rates of return for different companies with identical valuation if the managements of the companies differ in efficiency. While problems of valuation and fair rate of return have attracted more attention than the problem of arriving at prices which will bring in the fair rate of return on the fair valuation, this latter problem is a very trying one.

Public utility valuation and rate regulation are so complicated that they are often dealt with in complete volumes, but enough has been said in the present chapter to enable the reader to appreciate their difficulty. Under the circumstances, it is not surprising that attempts by several agencies to determine the fair valuation and fair return for a public utility company have resulted in valuations

which varied by hundreds of millions of dollars, and in proposed earnings in which the largest exceeded the smallest by 100 per cent.

Another Method of Rate Regulation.—The difficulties of the fair-return-on-the-fair-valuation approach are so great that in some cases commissions have abandoned this method of regulating rates and adopted what might almost be called a rule-of-thumb method. In Massachusetts, for example, the commission is said to take into consideration principally the economic situation of the company. It considers whether the company is paying dividends on its stock, whether the stock is selling at or above par on the market, whether the company is providing adequate depreciation reserves and is accumulating a reasonable surplus, and whether its operating and maintenance expenses are being increased or decreased under current business conditions—and only then are they ready to hand down a decision in a rate case. The commission makes no attempt to give the public utilities a particular percentage rate of return on the value of their properties, but tries merely to control rates so that the companies may pay dividends high enough to keep the value of their stock above par and permit the companies to market additional securities, when necessary, at not less than par. This plan seems to have much to recommend it, but its standing, in the light of past utility decisions of the Supreme Court, is uncertain.

The Success of Public Utility Regulation.—It was necessary for the state governments to delegate the regulation of public utilities to public utility commissions, for direct regulation by state legislatures would scarcely be feasible. But it must be admitted that commission regulation has not been entirely satisfactory. This may be accounted for in part by the fact that the commissions have been set to work solving problems for which there are no wholly satisfactory solutions. Some commissions have been given adequate powers and ample expert assistance, so that they have been able to operate successfully, but the reverse is true in many cases.

Many conditions among public utilities which the commissions were expected to remedy have continued to exist. They have often been unable to prevent utility companies from inflating or writing up the value of their assets, or from selling securities to a much greater total value than the aggregate value of their assets. Indeed, it is probable that total overcapitalization in the public utility industry runs into billions of dollars. While the commis-

sions have usually discounted to some extent the claims of public utilities with respect to the value of their properties, it is nevertheless true that the official valuations of these properties have often greatly exceeded the amount of the actual investment. A fair rate of return on an excessive valuation is equivalent, of course, to an excessive rate of return on a fair valuation.

Even if the valuation were perfect and the rate of return fair, the common stockholders of a utility company might still receive an unduly high return on their investment, because of the low fixed rates of return to holders of bonds and preferred stock. When the valuation is excessive, and the fair rate of return represents a very high return on total actual investment, the earnings of common stockholders on their investment may run to four or five times the nominal fair rate of return. It is true, also, that commissions have been unable to prevent excessive discrimination between different classes of customers. Of course, no one contends that all customers should be charged the same rates for (say) electricity, regardless of the amount of power used or the hours at which they use it, but electric companies have been known to sell a large part of their power to other utility companies at less than cost, and to industrial users at but little above cost, while charging domestic or residential consumers from fifteen to twenty times the average cost of generating and transmitting the current.[1]

Weaknesses of the Commissions.—While the regulatory problems faced by the commissions are very complicated, it is probable that much of the ineffectiveness of regulation has resulted from the inadequacy of the powers granted to some commissions and to defects in their personnel. For example, in 15 of the 48 states, public utility commissions are either wholly or partially lacking in jurisdiction over the electric light and power industry. Only 32 states have granted their commissions the authority to prescribe a uniform system of accounting for public utilities, and yet, without something of this sort, it is almost impossible to determine the facts needed for valuation and rate-making purposes. The issuance of securities by utilities is supervised in only 25 states, and in fewer still can the commissions exercise any real control over the uses made of the funds derived from the sale of securities.

Members of the commissions are elected by popular vote in

[1] C D. Thompson, *Confessions of the Power Trust,* New York, E P Dutton & Co., Inc , 1932, pp. 216-227

some 20 states, although it would seem that positions requiring so high a degree of technical knowledge might better be filled by appointment. Both in these states and in others, a considerable staff of assistants would be desirable, but such staffs as there are may be described as wholly inadequate. The commissions themselves have more than three members in only 11 states, and are consequently often too small for effective work. Many commissions are handicapped by reason of insufficient funds, and in a few cases their functions are not clearly defined in the state laws.[2] Despite these weaknesses, the commissions have done much by way of setting up standards of service and safety for the utilities, although, as was previously stated, they have not been especially successful with respect to valuation and rate-making.

Interstate Public Utility Activity.—Two recent developments in the public utility field have conspired to make state regulation of the industry less effective than formerly. Many years ago, the business of the public utility was almost entirely local in character, but at present the services of a utility are often sold, at least in part, in other states than the one in which the company is located. Electric power is the public utility product which enters most largely into interstate commerce. This interstate business has created a curious "no man's land" of regulation. The Supreme Court has held that state commissions have no power to regulate rates or other matters in the case of electric power sold at wholesale by a company in one state to a company in another state for distribution in the latter. However, when a company in one state sells a public utility service directly to consumers in other states, the Court has ruled that such business may be regulated by the states unless and until the federal government itself attempts regulation. These interstate activities of public utility companies are pretty clearly a part of interstate commerce and subject to federal control, but they are a complicating factor in state regulation.

The Development of Holding Companies.—Another factor which has arisen to hamper state regulation of public utilities is the development of holding companies. Holding companies, as we shall see, may exert a tremendous influence for good or evil in the public utility field, but they are scarcely amenable to state control. They are connected with the public utility industry

[2] This information is from C M. Clay, *The Regulation of Public Utilities*, New York, Henry Holt & Company, Inc, 1932, pp. 144-149

only through owning, directly or indirectly, a controlling interest in the stocks of actual public utility operating companies. Since they produce no utility services themselves, they do not come under the jurisdiction of public utility commissions; and, since many of them operate in two or more states, they have not been readily controlled by the individual states. The problem of the holding companies has become so important that in 1935 the federal government made an attempt to control them and their activities. Before considering this attempt at federal control, we must look into the organization and practices of these companies.

Holding Companies

The Nature of Public Utility Holding Companies.—Any company which holds the stock of other concerns may be called a holding company, but the term is usually reserved for companies that own a controlling interest in the stock of other companies and actively direct the affairs of these corporations. In the public utility field, a "first-degree" holding company is a corporation that owns a controlling interest in the stock of one or more operating utilities (those which really produce and sell electricity or some other service to the public) and that directs the business activities of the operating company or companies. A "second-degree" holding company will own a controlling interest in the stock of one or more "first-degree" holding companies, each with a group of operating companies under its control. Similarly, there may be holding companies of "third degree," "fourth degree," and so on. Holding companies, of course, are not limited to the public utility field. They exist in many of our major industries, but the problems which they present are probably of greatest significance in the field of public utilities, and it is primarily in this field that holding companies above the first degree are found.

The Financial Functions of Holding Companies.—The champions of holding companies in the public utility field claim that many advantages result from the operation of these corporations. A principal function of holding companies is to furnish capital to operating companies. Public utilities require a heavy investment in fixed capital, and much new capital is needed from time to time for extensions and improvements. Public utilities in towns and small cities have often secured from local sources the funds with which to start in business, but they have often found it difficult to raise funds for extensions and improve-

ments. They have been in a poor position to appeal to investment bankers for funds to be obtained through the issuance of securities, because they were small and unknown and lacked diversity of resources. In this connection, holding companies have been of assistance. They have accepted the securities of the small operating companies in exchange for needed funds, later recovering their outlay by marketing their own security issues, which were readily salable because the holding companies were comparatively large and well known and possessed resources (through the operating companies) which were well diversified in both character and location. Even when the security market has not seemed to be in condition to absorb new securities, the operating companies have often obtained funds from their holding companies by direct loans. Through the operation of holding companies, the individual operating companies are able to secure capital on better terms than those on which they could secure it for themselves. It is claimed that such financial support has helped to improve the quality and reliability of service in small communities, and to replace small, inefficient plants with large, modern generating stations.

Other Holding Company Functions.—Another benefit credited to the holding company is its ability to save money for its operating companies by acting as their purchasing agent. By purchasing at one time machinery, equipment, materials, and supplies for a number of operating companies, the holding company can buy in very large lots and obtain, in addition to lower prices, such advantages as better service, quicker delivery, and a prompter and more satisfactory adjustment of claims than the individual operating companies. Again, the holding company, with a number of operating companies under its wing, can afford to have a department or a subsidiary company to provide the operating companies with expert construction and engineering service at a price lower than the operating companies would have to pay outside concerns. The holding company can also give its small operating companies the benefit of high-class managerial ability and the experience which would otherwise be available only to the largest companies. Finally, it is often possible for holding company organizations to supply service to farms, and to small communities which could not themselves support public utilities.

It would seem that, if there were no offsetting disadvantages, the holding company would be the fairy godmother of the public

utility industry, transforming, as by a wave of the wand, inefficient, high-cost operating companies into efficient, low-cost enterprises, and furnishing managerial and other services, materials, supplies, and capital to the operating companies on most reasonable terms. Without the holding company, it might be argued, many of our public utilities would be unable to operate, or could continue in business only by charging higher rates than at present. Why should anyone want to destroy or regulate so useful an organization? But there is, unfortunately, another side to the picture.

The Pyramiding of Holding Companies.—If operating companies may enjoy these several benefits through the device of the holding company, it would seem that most of these advantages could be realized through the assistance rendered by a first-degree, or at most by a second-degree holding company. But our existing holding company systems have not stopped at the second degree. Many of them have at the top a holding company which is several times removed from the operating companies in its fields. According to a well-known writer on financial organization:

> Out in Oregon, you find a little company called the Yawhill Electric Company. It belongs to the Portland General Electric Company. But the Portland Company belongs to the Pacific Northwest Public Service Company. This might be thought to be the parent organization. It controls the public utilities of Portland, the gas company in Seattle, and street railways and other utility companies in various towns. But this is not the end of the maze. The last-named company belongs to the Central Public *Service* Corporation, which owns other utility systems in Delaware, Maryland, and Virginia. And that in turn belongs to the Central Public *Utility* Corporation, which owns various other holding companies, with utilities and other sorts of enterprises from Maine to Oregon.
>
> But this is still not the end. The Central Public *Utility* Corporation is held by a super-holding company called the Central Public Service *Company*. Why the little Yawhill Electric Company in Oregon, the Tri-City Gas Company in Alabama, the Bridgewater Electric Company in Maine, and the Lower St. Lawrence Power Company in the Province of Quebec, plus a maze of companies (including the Compagnie d'Éclairage Électrique in Haiti) in a dozen or more states, should all be huddled in this same holding company nest, no one can explain. And the interests which support these weird structures are powerful. Nothing short of action by the federal government, and

plenary power in the agencies entrusted with the job, can clean up such situations.[3]

This should not be considered an exceptional case, for it is asserted that, in some public utility systems, the top holding company is ten to fourteen stages removed from the actual operating companies. As to geographical distribution, it is well known that the Electric Bond and Share Company had operating companies in 36 states, and that each of eight other utility systems had operating units in from 11 to 29 states. While such complicated and widespread systems may not be justified from the point of view of the operating companies or the public, it is clear why the holding companies themselves desire to build up these complicated systems.

Power and Profits.—The reason is this: As holding company is piled upon holding company, power and profits become increasingly concentrated in the hands of the few men who control the topmost holding company. The point may be illustrated by the following hypothetical example given by the Federal Trade Commission:

Suppose there are 100 local power companies, the aggregate total investment in which is $1,000,000,000, each owned and operated by a separate corporation. The total investment might have been raised by the sale in the aggregate of $200,000,000 of common stock, $200,000,000 of 7 per cent cumulative preferred stock, and $600,000,000 of 6 per cent bonds. If these companies are permitted by public authorities to earn 8 per cent on the total investment, or $80,000,000 annually, of this, $36,000,000 would be required to pay the bond interest and $14,000,000 as dividends on the preferred stock. This leaves $30,000,000 for the common stockholders, either to draw as dividends or to use in further expansion of the business. This amounts to 15 per cent on the common stock investment and has been made possible out of the 8 per cent earned on the total investment only because the major portion of the total invested funds was furnished by two classes of investors whose per cent of return is limited.

Suppose, however, a particular group of promoters would like to make more than 15 per cent from these power company investments, and for this purpose forms a holding company with a total capital of $200,000,000 (the amount of the common voting stock of the operating companies), consisting of $100,000,000 of 6 per cent collateral trust bonds or 6 per cent debentures, $50,000,000 of 7 per cent cumulative

[3] J. T. Flynn and P. H. Gadsden, "The Holding Company Bill," *Forum and Century*, May, 1935, pp. 259-265.

preferred stock, and $50,000,000 of common stock. This group may be able to furnish the common stock money and persuade others to furnish the bond and preferred stock money, or, furnishing the common stock money, they may persuade the holders of the common stock of the local operating companies to exchange those stocks for this cash, together with the collateral trust bonds and preferred stocks. Now the $30,000,000 earned by the local operating companies on their common stock equities would accrue to the holding company. Out of it $6,000,000 would go as interest on the bonds and $3,500,000 would go as preferred dividends. This would leave $20,500,000 for the group of promoters who hold the common stock of the holding company, which amounts to 41 per cent on their investment of $50,000,000.

This group, however, might not be satisfied with this arrangement, or it might not have as much as $50,000,000 to invest. Suppose, therefore, that, instead of providing one holding company, it provides ten, dividing the local operating companies among them, the aggregate capital of the ten companies being the same as in the preceding case and of the same proportional structure in common stocks, preferred stocks, and bonds. Now suppose that the promoters organize a super-holding company with a total capital of $50,000,000 (the amount of the common stock of the ten subsidiary holding companies) consisting of $25,000,000 of 6 per cent bonds, $12,500,000 of 7 per cent cumulative preferred stock, and $12,500,000 of common stock. The promoters furnish the common stock money, thereby retaining for themselves the entire voting power in the whole pyramid of companies and constituting themselves the ultimate beneficiaries of the group's earning power, and sell the other securities to the investing public. The $20,500,000 of income left after paying interest and dividends on the bonds and preferred stocks of the operating companies and of the subsidiary holding companies accrues to this super-holding company. Out of it, $1,500,000 is required for interest on the super-holding company's bonds and $875,000 for dividends on its preferred stock. This leaves $18,125,000 for the common stockholders, or 145 per cent per year on the investment of $12,500,000 made by these promoters.[4]

This illustration shows that a small group of promoters, by investing $12,500,000, could gain control of $1,000,000,000 worth of operating companies, and receive their money back 1½ times each year—and the topmost holding company in this example is only of the second degree! By controlling more operating companies and carrying the holding company structure to greater heights, even better results could be obtained. Moreover,

[4] Senate Document Number 213, 68th Congress, 2nd Session, pp. 173, 174, cited in C. D. Thompson, *Confessions of the Power Trust*, pp. 181-183.

this illustration assumes that each successive holding company has acquired *all* the common stocks of lower companies, which would not be necessary for purposes of control. It also counts as profits of the topmost company only the income received indirectly from the operating companies' earnings. But holding companies also make profits from fees charged for various kinds of services performed for the operating companies. All in all, it is evident that the operations of holding companies may be very profitable to the "insiders."

The Duping of Investors.—The above description suggests that, when the business is profitable, the small group of common stockholders of the topmost holding company is in a position to get most of the cream. And, when the business is unprofitable, most of the loss is borne by the holders of the other securities, since they have furnished most of the invested funds. In this connection, it should be noted that holding companies have sometimes been guilty of unloading very poor securities on investors. A first-degree holding company holds as its principal assets the common stock of the operating companies which it controls. It has, then, a claim, partial or complete, on the residual earnings of these companies. On the basis of this stock, however, the holding company often sells one or more issues of bonds and possibly three or four issues of preferred stock, while retaining control in the hands of a small number of persons through ownership of the common stock, or such part of it as has voting power. The holding company may pay exorbitant prices for the stock of operating companies and then proceed to sell an amount of its own securities which is far in excess of the real value of the securities which it owns.

While there may be justification for the issuance of bonds by a first-degree holding company, the fact remains that, as bonds are issued by holding companies further and further removed from the operating companies, these "bonds" become distinctly less secure than the common stock of many industries. The same is true, and to an even greater extent, of the preferred stock of high-degree holding companies. Take, for example, the case of a holding company of the fifth degree. Its assets consist largely of the stock of other holding companies. This stock represents a partial, residual claim, four times removed, on the residual earnings of the operating companies in the system. However attenuated this claim might seem to us to be, the fifth-degree

holding company would often, upon the strength of this claim, issue securities which they called bonds, but which lacked almost wholly the certainty as to principal and interest which used to attach to securities bearing this name.

We see, then, that holding companies have sometimes issued securities, on the basis of fictitious asset values and paper profits resulting from stock dividends and other intercompany transactions, which did not truly represent the sums invested in underlying utility properties. These securities, issued merely on the hope of excessive income from subsidiaries, were likely to bring losses to investors. As one public utility company executive put it, "I know of no more reprehensible abuse than for speculators to buy up companies for high prices, put them into a holding company, and then, by trading on the credulity of the investing public relative to claimed increases in economy, to unload the holding company's securities at advanced prices and thus get completely out from under before the bubble is punctured, leaving the unfortunate final investor to face an angry consumer."[5]

Evils of Intercompany Relationships.—Sometimes a holding company system has been so large that the top holding company, in addition to selling bonds and preferred stock, has had to sell part of its common stock to the public, leaving only enough in the hands of the insiders to enable them to control the system. In instances of this kind, the large profits left after paying bondholders and preferred stockholders, when business was good, had to be shared with these outside common stockholders. In such cases, but more particularly when the income arising from the subsidiary companies, though sufficient to pay bondholders and preferred stockholders, was not sufficient to pay large returns on common stock, those in control of the topmost company have sometimes found it desirable to tap the income of subsidiary companies at its source. This might be done in any of a number of ways.

Those in charge of the topmost holding company control the affairs of the subsidiary holding companies and the operating companies as well. They have the power to appoint, directly or indirectly, presidents and managers for the operating companies and determine their salaries. Often they have appointed themselves or their associates as officials of the subsidiary companies, at very

[5] Samuel Ferguson, President of the Hartford Electric Company, in the *Electrical World,* March 20, 1926.

choice salaries and occasionally with generous arrangements for pensions in their old age. Funds for these purposes came, of course, from the payments made by consumers for the services of the operating utility companies.

Moreover, the men in control of the highest holding company often owned other companies which sold machinery, equipment, materials and supplies, of the types required by the operating companies, or sold construction and engineering services. Hence, they were able to sell the operating companies commodities and services at virtually whatever prices they chose to charge. If, for example, the manager of a small electric company needed (say) a new dynamo for his plant, he would submit the matter to the manager of a holding company in another place. The holding company manager would tell him whether he could have the money for the operating company, how much he could have, just what he should buy with it, from whom he should make the purchase, and what price he should pay. This would often result in the equipment being purchased from a company owned by the men at the top, and at a price which they themselves fixed. If this company charged the local operating company too much for the equipment, nobody but the insiders would be any the wiser.

In these and other ways, those in control of a holding company system could often find ways to line their pockets without sharing the income of subsidiary companies with other people. The practice of charging exorbitant prices to operating companies for machinery and equipment was important not only from the point of view of "milking" the operating companies, but also because the rates the operating companies were allowed to charge were usually determined by public utility commissions on the basis of permitting these companies to earn a fair rate of return on the cost of the property of the companies used and useful in the public service. Hence, the rates paid by consumers might be unduly high because of the high prices paid by operating companies for equipment. Finally, it will be recollected that a major claim for the holding company is that it makes it possible for the operating companies to obtain capital which they themselves might not have been able to attract. However, this process has sometimes been reversed and the operating companies have been compelled, to their detriment, to make "upstream loans" to their holding companies.

Propaganda and the Control of Legislation.—We must mention, also, as an evil related to holding companies, the extent to which these corporations have attempted to influence legislation in which they were interested. It was perhaps but natural that holding companies, in a country in which other large concerns or industries indulge in such practices, would try to influence legislation through lobbying, bribery and other methods. These methods, however, were quite as likely to be used against legislation designed to correct evils of the holding company as in favor of that proposed for the benefit of holding companies and operating companies alike. When the Holding Company Bill was before Congress in 1935, many holding companies spent large sums of money to defeat this measure. The funds were sometimes obtained through "contributions" made by the operating companies, or, again, came out of income received from operating companies in the regular course of business. In effect, then, the purchasers of utility services were paying to defeat a law intended, in part at least, to protect their interests as consumers. In addition to direct lobbying, the holding companies sought to induce security holders to write or telegraph their Senators and Congressmen urging the defeat of the bill. It was testified at a public hearing that public utility officials sent many identical telegrams denouncing this bill, signing them with names taken at random from telephone directories, and without the authorization of those whose names were used.

It has also been charged, and at least partly proved, that holding companies have conducted long and expensive campaigns of propaganda to influence public opinion in their favor. At times newspapers have been bought outright to insure favorable publicity for the industry. More often such publicity has been obtained through cordial relations established by heavy advertising in these newspapers. There is some evidence that college professors have been kept on public utility payrolls so that they might preach the gospel of the utilities; and the industry has also been successful in changing the content of some textbooks and inducing school authorities not to use others which contained unfavorable references to the industry. Utility companies have also been most generous in providing favorable materials about the industry for use in the schools.

The Question of Rates.—Prominent utility officials have often contended that, whatever might be the evils of holding companies,

the rates charged by operating companies to the consumers have not been adversely affected by holding company control. Since the operating companies are only allowed to charge rates which will produce a fair return upon a fair valuation of their properties, it is said to matter little to the consumers how thoroughly watered the securities of holding companies may be, or what happens to the income of operating companies once it is received. Indeed, these officials have contended that the progressive reductions which have taken place in public utility rates indicate the benefits to consumers of utility operation under the holding company system. There may be question as to how general these reductions have been, but there is no doubt that they have occurred in some cases. However, those which have occurred in the past few years must be discounted to a considerable extent as having possibly been produced by the threat of regulation, rather than by lowered costs.

In any case, the lowering of absolute rates means comparatively little. That is, the low rates charged today may be further above the cost of production than were the higher rates charged in previous periods. The dealings of holding companies with their operating companies have been secret, and we have had no way of knowing whether the price paid for (say) electricity in a given community was, on the basis of costs or by comparison with the rates charged elsewhere by other operating companies under the same holding company control, a fair price.

We have now reviewed briefly the principal merits attributed to public utility holding companies, as well as the principal evils with which they are charged, and are in a position to examine and appraise the public utility legislation of 1935. At this point it is only fair to say that the evils pointed out have by no means been characteristic of all public utility holding companies. Some, indeed, have enviable records for fair dealing with both their subsidiaries and the public, but others have been guilty of most, if not all, of the malodorous practices that we have described.

The Wheeler-Rayburn Public Utilities Act

The holding company situation in the public utility field was so serious, and the powers of the state governments to control them were so feeble, that in 1935 the federal government undertook to provide regulation through the Wheeler-Rayburn Public Utilities Act. This was and is a controversial piece of legislation

which has aroused much discussion and criticism. While it was under consideration by Congress, the newspapers opposed to the Roosevelt administration played up the "proposed destruction of a twelve-billion-dollar industry" and printed editorials setting forth the foolishness of burning down a house to get roast pork or tearing it down to rid it of rats! To those who were convinced by these appeals, the passage of the bill must have seemed one of the greatest of modern tragedies.

The Act consists of two parts. Title One is the Public Utility Holding Company Act, while Title Two—the Federal Power Act—applies to all companies owning or operating facilities for transmitting electrical energy or selling it at wholesale, in interstate commerce. The Act is verbose and involved, and delegates sweeping powers to the Securities and Exchange Commission. In Title One it sets forth, as its reason for existence, the fact that public utility holding companies are affected with a national public interest, because their securities are sold and distributed, contracts are made and performed, and gas and electricity sold and transported, through the mails and other instrumentalities of interstate commerce. It declares, further, that the public interest and the interests of investors and consumers may be adversely affected by lack of adequate information and of adequate control over contracts and services, by obstacles to effective state regulation, by lack of economy, and by other abuses necessitating federal regulation.

The Act defines such terms as "holding company," "subsidiary company," "affiliated company," and "mutual service company." It defines a holding company as any company which has, directly or indirectly, 10 per cent or more of the voting control of a public utility company or another holding company; and as any person found by the S.E.C. to exercise alone, or in combination with others, such control or influence over a public utility company or holding ocmpany as to make it necessary in the interests of the public, investors or consumers that such person be brought under the influence of the Act. Holding companies are brought under the jurisdiction of the S.E.C. by the provision that every holding company, which, on October 1, 1935, had outstanding securities offered since 1925 and owned to some extent in other states, must register with the Commission in order to remain in business. The Commission is empowered to exempt certain companies from registration under conditions too detailed to be

described here. To secure registration, holding companies must produce full and complete information about their capital, resources, officers and business. Periodic and special reports must be filed with the Commission.

Financial Matters.—Several provisions of the Act are designed to correct specific evils that have marked the development and operation of holding companies. A uniform accounting system is prescribed for registered holding companies, and it is unlawful for any registered holding company or subsidiary company to acquire securities or capital assets of other companies without the approval of the S.E.C. The issuance of new securities by holding companies also comes under the jurisdiction of the Commission. Security issues must be well adapted to the financial structure of the issuing company and to its earning power; the financing must be necessary and appropriate to the economical and efficient operation of the business; fees and commissions in connection with the security issues must be reasonable; in cases of guaranty or assumption, the risk must not be improper; and the terms of sale must not be detrimental to the interests of the public, investors, or consumers. The purposes of security issues must be approved by the S.E.C. No-par stock, preference stocks, and debentures may no longer be issued.

Holding companies and subsidiaries may not declare or pay dividends in violation of such rules as the S.E.C. may prescribe to protect the financial integrity of the system, safeguard working capital, or prevent payments out of capital or unearned surplus. The acquisition or redemption, by a holding company, of its own securities, the sale of its own securities or other utility assets, and the solicitation of proxies, powers of attorney, and the like, are prohibited except under rules set up by the S.E.C. Holding companies are forbidden to sell securities from door to door, and to require subsidiaries to sell holding company securities. "Upstream loans," from operating companies to holding companies, are prohibited and other loans are regulated.

Contributions of holding companies or subsidiaries to any political party or candidate are strictly prohibited. Utility lobbyists must register with the S.E.C., and disclose the subject matter on which they work, the fees they receive, and other specified information. Officers and directors of holding companies must file statements listing the securities of the holding companies and subsidiaries owned by them, and must make monthly

reports of any changes in ownership. To prevent the misuse of inside information, profits realized by officers and directors from buying and selling such securities within any six-month period shall inure to, and be recoverable by, the companies, regardless of the intent of the officers and directors.

Other Intercompany Relations.—Holding companies are no longer permitted to sell to operating companies directly, or through a subsidiary company, the various types of commodities and services which we have mentioned, at whatever prices they choose to set. On April 1, 1936, it became illegal for a registered holding company to enter into or perform any service, sales, or construction contract for an associated public utility company or mutual service company. A subsidiary of a registered holding company or a mutual service company may do these things only in accordance with the rules, regulations, and orders of the S.E.C., to insure that the contracts are performed at cost and that the burden of cost is fairly divided among the associated companies. Again, on August 26, 1936, it became illegal for a registered holding company or subsidiary to have, as an officer or director, any officer, partner, or representative of a bank, trust company, investment banking house, banking association or firm, or of any corporation a majority of whose voting stock was owned by any bank, trust company, investment banker, banking association or firm, except as the S.E.C. might permit.

The Act attempts to confine the activities of holding companies to the operation of gas and electric utilities and the holding of securities of such utilities. It is intended to prevent the indiscriminate combination of domestic and foreign utilities, and to prevent the use of the holding company to deny to the public the widespread and economical use of both natural gas and electrical energy, which are sometimes withheld merely because it is to the selfish advantage of a company to encourage the use of one of its products rather than another and deprive the public of the benefits of competition between the two.

The Original "Death Sentence."—The most famous provision of the Holding Company Act is the clause which contains the so-called "death sentence" for public utility holding companies. The student may wonder why the regulations detailed above were included in the Act if holding companies were to be eliminated. But, as we shall see, not all holding companies are to be eliminated. The regulations will govern the activities of

those which are to continue, and of the doomed holding companies during the period prior to their dissolution.

The original Senate bill would have required the dissolution of all holding companies, except those of the first degree, by 1940, and the dissolution of first-degree holding companies by 1942 unless they were found by the Federal Power Commission to be in the public interest. In such cases, the burden of proof was upon the first-degree holding companies. The House of Representatives refused to pass the bill while it contained this clause, and finally substituted another clause providing for the dissolution of all holding companies by 1940, but giving to the S.E.C. authority to permit the continuance of these companies unless their dissolution was found to be necessary in the public interest. Under this provision, the burden of proof was to fall on those who wanted the holding companies dissolved.

The Compromise "Death Sentence."—After a long series of conferences, the House and Senate finally agreed upon a compromise "death sentence" clause. This clause directed the S.E.C., after January 1, 1938, to require by order that existing utility holding company systems be limited to one such company, and one subsidiary holding company, and to prevent control by the two companies over more than one integrated system of operating companies. Thus, the "death sentence" now apparently applies only to holding companies above the second degree. According to the Act, an integrated system of operating companies is a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more companies, are physically interconnected, or capable of physical interconnection, and which under normal conditions may be economically operated as a single interconnected and coordinated system, confined in its operation to a single area or region, in one or more states, and not so large as to impair (considering the state of the arts and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

No exceptions are permitted as to the degree of the holding companies, but exceptions may be allowed in the number of operating systems to be controlled by the two holding companies in a system. Thus, more than one integrated operating system may be controlled whenever the Commission finds that such additional systems are incapable of economic independent operation

or operation without the loss of substantial economies not otherwise obtainable, when the additional systems are located in the same state or adjoining states, and when the continued combination of the operating systems is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The burden of proof in each case is on the holding company.

The Regulation of Holding Company Activities.—It is still too early to say what the final effect of the public utility legislation of 1935 will be upon the industry. Apart from the "death sentence" clause, the principal criticism of the Act by public utility officials is that it goes too far in regulating the activities of holding companies, and places unduly broad powers in the hands of the Commission. When a situation has become very serious, the first attempt to correct it through legislation sometimes produces a law that is too severe. However, the regulatory provisions of this Act are apparently directed at specific and well-known evils, and, apart from the fact that the holding companies could engage in activities closed to operating companies, the powers delegated to the S.E.C. are not very different from those exercised by public utilities commissions in some states. Of course, the successful regulation of specific activities of holding companies will depend largely on the wisdom and skill with which the S.E.C. administers the law.

The Welfare of Operating Companies and Consumers.—As we have said, much of the controversy over the Act has centered about the "death sentence" clause. This clause was attacked from several angles, one of which related to the welfare of the operating companies and of the consumers. It was said that the destruction of the holding companies would ruin the industry because the operating companies were dependent upon the holding companies for expert managerial services, supplies, equipment and capital. With the holding companies gone, the operating companies would have to depend upon their own resources and would be unable to operate with their customary efficiency. The result would be higher rates for consumers, or perhaps even the outright failure of operating companies and a growing need for government ownership. Indeed, it was sometimes charged that the aim of the Act was eventually to bring all public utilities under government ownership.

Supporters of the Act do not deny that many operating com-

panies are dependent upon holding companies for capital, services, and commodities, and that the efficiency of these operating companies would be impaired if all holding companies were eliminated. They point out, however, that not all holding companies are to be dissolved, but only those above the second degree. It is probable that operating companies already derive a major part of their benefits from holding companies of the first or second degree. Even if this is not true now, there is no reason why first- and second-degree holding companies should not be able, after a reasonable period of time, to furnish all essential capital, commodities, and services to the operating companies. If this development takes place, holding companies above the second degree will perform no useful economic function, and their dissolution will not involve loss to the operating companies and consumers. And any loss of efficiency that might occur, it is suggested, would be more than offset by the elimination of evils which have resulted from the activities of these high-degree holding companies.

Even though the holding companies of high degree may not be missed, it might be uneconomical to deprive a first- or second-degree holding company of all but one of its integrated systems of operating companies. But, as we have seen, a holding company may be permitted to continue its control over more than one system of operating companies, whenever such control is in the public interest. In other cases, holding companies must be reorganized, or new holding companies organized, so that only one system of operating companies will be controlled by each. Given a reasonable period of time, it should be possible to accomplish the necessary reorganization with a minimum of loss to those involved.

The Destruction of Investments.—There are many who contend that, while the dissolution of high-degree holding companies may be good riddance from the point of view of operating efficiency and consumer rates, their loss will be mourned by people who have invested in their securities. It is argued that the government, by forcing the liquidation of these companies, will destroy the investments of their preferred and common stockholders, though the bondholders may get their money back. Let us suppose that a third-degree holding company is forced to liquidate. This means disposing of its holdings of securities of other companies, and selling its other assets. Out of the meager proceeds realized from the forced sale of its assets, the company will first have

to pay the bondholders in full and there will be little or nothing left for the stockholders.

Supporters of the Act admit that the investors in certain holding company securities are deserving of sympathy. Undoubtedly, some of these "investments" have lost their value completely, or almost completely. They contend, however, that the government is in no sense responsible for these losses to security holders. Rather, the responsibility rests with the holding company executives, who sold worthless or questionable securities at high prices in the gala days of 1929 and earlier. The solicitude of these executives for the security holders is touching, but untimely.

It seems apparent that many high-degree holding company securities had lost most if not all of their value before the Act was passed or was in any danger of passing. For example, shares in American Gas and Electric sold in 1929 for as much as $225 per share and fell to $18⅞, while shares in Associated Gas and Electric, which had brought $46, were later offered at 39 cents each. Of course, as utility executives claim, not all holding companies should be blamed for the misdeeds of the guilty, but in 1929 the control of about 40 per cent of the power industry was concentrated in the hands of three large groups—the Insull group, United Corporation, and Electric Bond and Share. The stock of these companies sold in 1929 for as much as $79, $75, and $189, respectively, and during the depression went as low as 0, $1½, and $3⅝ per share, respectively.

Since the shares of many holding companies had dropped, before holding company legislation became at all imminent, to a figure which was only one to five per cent of their former values, the supporters of the law suggest that something more than the prospect of adverse legislation depressed their values. They also suggest that the holding company officials, who now weep over the fate of the utility investor at the hands of a cruel government, may be shedding crocodile tears. The man who bought the stock of a high-degree holding company at $75 a share, and watched it fall to $1½ under a governmental policy of "hands off," is not likely to be impressed by the charge that the government, through the operation of the Wheeler-Rayburn Act, is going to destroy the value of his shares.

Let us see how the Act is likely to affect the owners of securities. If we are correct in assuming that, after a period of reorganization, all holding company functions contributing to the

efficiency of operating companies can be performed by first- and second-degree holding companies, those who hold the securities of the operating companies should not suffer through the operation of the Utilities Act. Similarly, the holders of the securities of first- and second-degree holding companies should not be affected adversely, since those which are sound and perform a useful economic function will not be dissolved. And, of course, the securities of both operating and holding companies should increase in value as we move from depression, through recovery, and into prosperity.

We may agree that the holders of stock in high-degree holding companies are in an unfortunate position, while denying vigorously that this situation is attributable to the Utilities Act. Rather, the losses that the stockholders suffer will have resulted chiefly from the fact that they were inveigled into paying very high prices for stock which was essentially and inherently unsound. In other words, they were sold securities whose total price was far in excess of the value then existing or probable future value of the assets of the high-degree holding companies whose stock they bought. The Utilities Act must indeed be embarrassing to the gentlemen who foisted these securities on the public, but such embarrassment scarcely constitutes a valid criticism of the Act.

Constitutionality of the Wheeler-Rayburn Act.—The constitutionality of the Act has been strongly challenged in the courts. When the time came for holding companies to register with the S.E.C., many refused to do so until the constitutionality of the Act had been determined. In February, 1938, it was estimated that holding companies controlling 56 per cent of the assets of utility companies subject to federal regulation had failed to register.[6] In March, 1938, the Supreme Court ruled that the registration provisions of the Act were constitutional. The Court held that the holding company involved in the suit in question was clearly, though to some extent indirectly, engaged in interstate commerce, and that, equally clearly, the registration provisions of the Act came within the power of Congress to regulate interstate commerce.

Following this decision, several important holding companies hastened to register, but the battle is still on with respect to other matters, for the constitutionality of the "death sentence" feature of the Act remains in doubt. This provision was to be enforced

[6] *Chicago Tribune*, February 25, 1938.

as soon as possible after January 1, 1938, but the S.E.C. delayed its enforcement because of the uncertain status of the Act. The clause was invoked for the first time in July, 1938, when the S.E.C. set August 9, 1938, as the date for a hearing to determine why the Utilities Power and Light Corporation, a $300,000,000 concern with forty-six subsidiaries located in fourteen states, Canada, and England, should not comply with the "death sentence" clause.[7] In August, 1938, the S.E.C. set December 1, 1938, as the final date for the submission of reorganization proposals by all holding companies under the "death sentence" clause. On that date, the Commission announced that public utility holding companies representing "substantially 100 per cent" of the assets of the industry had furnished the Commission with plans for simplifying their corporate structures, as required by the Act. Eventually, the Supreme Court will pass upon this phase of the law. In any event, however this particular Act may fare at the hands of the Supreme Court, it is difficult to see how holding companies can be effectively regulated by any agency other than the federal government.

The Federal Power Act.—Title Two of the Public Utilities Act of 1935 gives the Federal Power Commission jurisdiction over all facilities used for the transmission and sale of electric energy in interstate commerce, and over the sale of electric energy at wholesale in interstate commerce. The Commission is directed to divide the country into regional power districts, and to encourage interconnection and coordination of facilities within each district and between districts. Upon application of any state commission or person engaged in the transmission of electric energy, the Commission may direct a public utility (if it finds that no undue burden is thereby placed upon the utility) to connect its electric transmission facilities with those of one or more persons engaged in the transmission or sale of electrical energy, and to sell energy to or exchange energy with such persons. However, the Commission may not require the extension of generating facilities for these purposes or compel any utility company to exchange or sell energy when to do so would interfere with its ability to provide satisfactory service to its regular customers.

In case of war, or a shortage of electric power or facilities, the Commission may, upon its own motion or by request, compel a temporary connection of facilities and such generation, exchange,

[7] *New York Herald Tribune,* July 21, 1938.

or transmission of power as in its judgment will best provide for the emergency and care for the public interest. For interstate purposes, the Commission has powers of control over electric utility companies similar to the powers of the S.E.C. over holding companies. That is, it controls interstate wholesale electric rates, the acquisition and sale of properties, the issuance of securities, and accounting methods. This part of the Public Utilities Act of 1935 aims to correct a weakness in the state public utility regulatory system, but it has been criticized as going further than necessary to accomplish this end. In any case, the criticism of Title Two of the Act has not been nearly so violent as that of Title One which we have examined at some length.

The Tennessee Valley Authority

The Nature of the T.V.A.—The public utility industry, in addition to its worries over the Wheeler-Rayburn Act, has been much concerned about the activities of the Tennessee Valley Authority. The T.V.A. is a corporation controlled by a board of three directors appointed by the President. It was organized in 1933, for the purpose of developing the Tennessee River Valley area. In 1934, when the T.V.A. project included six dams, with electric plants and transmission lines, it was estimated that the total cost would be $310,000,000. By 1937, the project had grown to include eleven dams (three in operation, four under construction, and four yet to be constructed), and the estimated cost had reached $520,000,000.[8]

The public utility industry is interested in the T.V.A. because all dams that are constructed are equipped to produce electric power, which may be marketed in competition with the electricity sold by the private utility companies. Indeed, it is frequently contended that the primary purpose of the T.V.A. is to produce and sell electric power. According to T.V.A. authorities, however, this is but one purpose among many. Other interests are flood control, the improvement of navigation, the production of fertilizer and explosives, and the rehabilitation of agriculture.

The dams permit flood waters to be stored up in great lakes, and it is said that they have already prevented millions of dollars' worth of damage along the Ohio and Mississippi Rivers. It is expected that a nine-foot waterway will be opened all the way from the Ohio River to Knoxville, Tennessee, to provide low-cost

[8] *Chicago Tribune,* March 9, 1938

transportation for freight, and to aid the farmers of the area in preventing soil erosion and improving agricultural conditions generally. In so far as electric power is produced, it is contended that the T.V.A. power plants are to be used as "yardsticks," to determine how cheaply electric power can be produced and transmitted, and in this way to find out whether existing rates in the district are fair and reasonable. It is also suggested that, if the private companies have to lower their rates for electricity because of T.V.A. activities, consumption will probably be increased so enormously that these companies will make greater net profits than in the past.

Criticisms of the T.V.A.—These considerations means little or nothing to critics of the T.V.A., who insist that the project is designed almost solely for the production and sale of electricity in competition with the output of private companies. The T.V.A. estimated, in 1938, that $49,360,170, or 52 per cent, of the $94,125,671 cost of the first three dams, should be allocated to power facilities. But critics contend that this is an underestimate of the cost of these facilities, and that the dams could have been built for a small fraction of their actual cost if it had not been for the desire to produce electric power.[9] To allocate too little to the construction of power facilities would be, of course, to lower artificially the cost of power production at the government plants.

It is charged that the use of these T.V.A. plants as yardsticks is unfair to the private companies, not only because of this artificially low estimate of original costs, but also because the T.V.A. does not charge against itself such items as taxes, depreciation, and interest, which must be paid by private companies. To have to compete with T.V.A. rates which are based upon such inaccurately estimated costs, would be ruinous to the private companies, it is alleged. Moreover, the critics question that the T.V.A. plants are to be used merely for yardstick purposes. They point out that the T.V.A. has already erected thousands of miles of transmission lines, and that it serves scores of communities and tens of thousands of industrial consumers. They point out, further, that the electric plants of the T.V.A., when completed, will produce about half as much power as is now sold in the seven states affected by the T.V.A., and that private companies are in some cases already being pressed to sell out to the government if they do not wish to compete with T.V.A. rates. Indeed, it was an-

[9] *New York Herald Tribune,* June 17, 1938.

nounced in November, 1938, that the T.V.A. and twenty-two Tennessee cities had agreed to buy out the West Tennessee Power and Light Company for $1,600,000. This company was a subsidiary of the National Power and Light Company, which had already sold its Knoxville distribution system to the T.V.A., and agreed to dispose of its system in Memphis. Most disturbing of all are reports that several other projects similar to the T.V.A. are to be started in other parts of the country; and the critics conclude that the public utility industry is to be destroyed, and government ownership substituted.

Constitutionality of the T.V.A.—In view of this conclusion, it is not surprising that utility companies have objected strenuously to the activities of the T.V.A. Recently, some eighteen utility companies in the southeastern part of the country brought suit, asking an injunction against the sale of power by the T.V.A., on the ground that their business was threatened with irreparable injury, if not destruction. The case came to a decision in a Federal Court in Chattanooga, Tennessee, in February, 1938. The court decided in favor of the T.V.A., holding that the utility companies have no immunity from lawful competition, even if their business is curtailed or destroyed. The judge decided that the T.V.A. dams were constructed for several other purposes—including navigation, flood control, and national defense—as well as for the development of electricity. The water stored by these dams, when allowed to pass through turbines, creates electric power. This power is the property of the federal government, and the Constitution empowers the government to dispose of its property in any way it may choose.

The utility companies immediately took an appeal to the Supreme Court, which has consented to review the decision of the district court. In addition to these court activities, a congressional investigation of the T.V.A. has been authorized and is now under way. Obviously, it will be some time before we know whether the T.V.A. activities are constitutional, and what their final effects upon the public utility industry will be.

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1. Why are some businesses called "public utilities"? Explain.
2. Why has it been thought necessary for the government to regulate public utilities?
3. How have our courts restricted the power of public utility commissions to regulate the rates charged by utility companies?

4. Why is the valuation of public utility properties necessary? What problems arise in connection with valuation?
5. What is meant by the prudent investment cost method of valuation? Explain fully.
6. Is either the total par value or market value of the stock of a utility company a sound measure of the value of its property? Why?
7. What problems are encountered in attempting to find the original cost of a utility company's properties?
8. Do you prefer reproduction cost or original cost as a method of public utility valuation? Explain.
9. What difficulties arise in attempting to establish a fair rate of return? Explain.
10. Is any principle of rate regulation feasible other than the "fair return on a fair valuation"? Explain.
11. "Despite regulation by public utility commissions, many evils have continued to exist in the public utility industry." Explain the nature of these evils.
12. What have been the principal weaknesses of public utility commissions?
13. How have two developments of fairly recent years still further impaired the ability of state commissions to regulate the utilities?
14. What is a public utility holding company?
15. How do holding companies perform certain financial functions for their operating companies? Explain.
16. What other functions are performed by holding companies for operating companies?
17. What is meant by the pyramiding of holding companies?
18. How are power and profits concentrated in the hands of a few individuals through the use of holding companies? Explain fully.
19. In what ways have holding companies sometimes been guilty of duping investors?
20. How have evils existed in the relations between holding companies and their subsidiaries? Explain.
21. How have holding companies attempted to influence legislation and public opinion?
22. What were the purposes of the Public Utility Holding Company Act of 1935?
23. How is the Securities and Exchange Commission expected to control the financial operations of holding companies under this Act? Explain.
24. How are intercompany relations regulated by the Act?
25. What is meant by the "death sentence" clause?
26. Explain the operation of this clause.

27. Will the welfare of operating companies and consumers be adversely affected by the operation of the Act? Explain.
28. Has the government, through this Act, destroyed the investments of the holders of the securities of high-degree holding companies? Explain.
29. Explain the provisions of the Federal Power Act of 1935.
30. What is the T.V.A., and how is it related to the public utility industry?
31. Discuss the controversy which is raging over the activities of the T.V.A.

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23 THE RELATION OF GOVERNMENT TO BUSINESS

FEW QUESTIONS AROUSE SUCH WIDE DIFFERENCES OF OPINION AS THAT OF THE PROPER RELATIONSHIP OF GOVERNMENT TO BUSINESS. There are some who hold up as the ultimate goal the complete abolition of government, so that the individual may be left free for self-expression. Many of our citizens believe in a *laissez faire*, or "let alone," policy on the part of government in so far as business is concerned. Such a policy presupposes the existence of government—but a government whose powers would be limited to the performance of a few vital functions, such as protection against foreign aggression; the maintenance of law, order and justice; and the conduct of education. Probably a majority of citizens are undecided with respect to the subject matter of this chapter. That is, they believe that the government should not interfere with or regulate business so long as its conduct by private individuals appears to be in harmony with the public interest to a reasonable extent. On the other hand, when a sharp conflict between private and public interests appears in certain businesses, they are willing to have the government step in and regulate these activities for the protection and benefit of the general public. Finally, at the other extreme, we have those who believe that economic power should be concentrated in the hands of the government and that the government should own and operate all industries.

Mercantilism.—Not only is there a wide range of opinion at any one time as to the proper relationship between government and business, but the dominant attitude toward this question has moved back and forth from time to time. Many of the economic and political ideas and institutions in the United States came originally from England. Prior to the Industrial Revolution, England had a political and economic system known as Mercantilism, which involved much government regulation of and interference with economic activity. Mercantilism sought to build up the wealth and power of the state, or nation, and attempted in particular to

control foreign trade so that England's exports might exceed her imports, and gold flow into the country in large quantities. But regulation was not confined to foreign trade. Many details of domestic economic activity were also controlled, certain industries were subsidized, and others were turned over to private individuals to be operated as monopolies.

Laissez Faire.—With the coming of the Industrial Revolution, government regulation began to lose its popularity, giving way to the advocacy of *laissez faire*, under which the functions and activities of government are brought to an irreducible minimum. Adam Smith expressed the attitude of *laissez faire* as follows:

> All systems either of preference or restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way. . . . The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and directing it towards the employments most suitable to the interest of the society. According to the system of natural liberty, the sovereign has only three duties to attend to: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions.[1]

The advocacy of *laissez faire*, then, was based upon the belief that each individual, in following his own self-interest, would be moved "as by an invisible hand" to act in such a way as to promote the welfare of society as a whole, as well as his own welfare. For example, a manufacturer tries to reduce costs of production so that he may undersell his competitors and make money for himself, but in so doing he confers a benefit upon other members of society by furnishing them with an economic good at a lower price than they would otherwise have to pay. It must be remembered, however, that he might confer a similar benefit on himself, though harming the interests of society as a whole, by working

[1] Adam Smith, *The Wealth of Nations,* London, Ward, Lock & Co , Ltd., p. 545.

his labor under sweatshop conditions or creating a monopoly to exploit the public. Nevertheless, it may be conceded that, in a relatively simple state of economic development, the "doctrine of economic harmonies" as here outlined, probably worked out fairly satisfactorily in a majority of cases.

At any rate, governmental restrictions and regulations were quite rapidly relaxed in England after the coming of the Industrial Revolution. The result was a development of industry and trade at an amazing pace, but at a heavy cost in terms of human welfare, for this economic development was attended by low wages, long hours, intolerable working conditions, the use of child labor, and, of course, an increasing dependence of laborers upon the owners of the other agents of production for a chance to work at all. Eventually, it became necessary to revive governmental regulation of economic activity to some extent, in the interests of public welfare.

The Constitution of the United States.—When the American Colonies became independent of England following the Revolutionary War, the attitude of *laissez faire* was already strongly implanted in the minds of our people, and this attitude undoubtedly influenced our fundamental law. Moreover, the Colonies, after the war, became not parts of a nation but independent states, so that the United States represented merely a banding together of sovereign states for certain purposes. When the Constitution was being formulated, the states were in many cases jealous and suspicious of one another. Since our federal government derived its powers from grants by the states, and not vice versa, it possessed only such powers as the states chose to confer upon it, all other powers being retained by the states. In view of the prevailing attitude of *laissez faire* and the existence of this situation between the states, the framers of our Constitution were determined to give the federal government only certain strictly limited powers. Among the principal powers granted the federal government were the maintenance of the army and navy, the control of interstate and foreign commerce, the regulation of coinage and currency, and taxation.

It should be remembered, also, that the federal and state governments were organized on the basis of a careful division of powers between the several departments of government. The legislative department was to be responsible for legislation, and public revenues and expenditures, the executive department was to

approve and administer the legislation, while the judicial department was given authority to mete out justice and interpret the statute and fundamental law. The powers of each department have been jealously guarded, and legislation which appeared to permit one department of government to usurp the functions of another department has sometimes failed to meet with the approval of the Supreme Courts, federal and state.

Early Economic Experience Under the Constitution.—For many years economic activity in the United States flourished and prospered under the governmental organization provided by the federal Constitution. A huge country like the United States, with abundant land, sparse population, and great natural resources crying for utilization, was a place in which the policy of *laissez faire* might be expected to operate successfully, by allowing each individual to pursue his own self-interest in any way which did not interfere with the similar right of others. The federal government restricted its activities to fields obviously within its jurisdiction, such as the maintenance of freedom of enterprise, the protection of the citizens in their use of, and against the abuse of, private property rights, and the guaranty of freedom of contract. It also engaged in activities which were intended to facilitate the conduct of economic life, such as the maintenance of the monetary system; the development of standards of weights and measures; public works, such as river and harbor developments, irrigation projects, and assistance in the development of transportation facilities; the granting of patents and copyrights; and the protection of domestic industry. There was almost nothing in the way of actual regulation of economic activity.

Eventually, however, economic problems arose which could not safely be left to solve themselves. The development of the railroads, the growth of the corporate form of business organization, the increase in the size of the business unit and formation of monopolies, abuses in the field of commercial and investment banking, the rise of a variety of labor problems, and the increasing seriousness of various problems resulting from recurrent periods of business depression, were matters which seemed to many people to demand at least a degree of governmental intervention. Many of these problems were national in scope, and seemed to be of a type which could not be handled successfully by a large number of independent state governments. Consequently, the federal government has had to broaden the scope of its activities.

The Constitutionality of Legislation.—The Supreme Court of the United States, in 1803, assumed the power of passing upon the constitutionality of federal and other legislation. That is, the Court undertook to decide, when cases came before it, whether the laws passed by federal and state governments were in conformity with the powers granted these governmental units by the Constitution, and to declare the laws null and void when such was not the case. This practice means that a law may be declared unconstitutional by the Supreme Court, even though it is wanted by a majority of our citizens, has passed Congress by an overwhelming vote, and is wholly desirable from the economic point of view. A law which is economically sound may be declared unconstitutional, while one that is unsound from the economic point of view may be pronounced constitutional. Of course, the process of passing upon the constitutionality of laws is not like feeding the laws into a machine from which they will emerge branded either "constitutional" or "unconstitutional." The language of the Constitution is often quite general and must be interpreted by the Court in one way or another. In making this interpretation the judges are pretty certain to be influenced by their background, training, and past experience, whether they realize it or not. Indeed, it sometimes happens that a law, which was declared unconstitutional at one time, is later, in almost identical form, given the approval of the Supreme Court. It has been said that the Constitution is whatever the justices say it is. At any rate, the Supreme Court, by defining and interpreting the powers granted to the federal government by the Constitution, actually decides what shall be the relationship of government to business in the United States.

Railroad Legislation.—Because of the limited powers granted the federal government by the Constitution, it has been necessary for the federal government to base most of its legislation dealing with economic problems, upon its power to regulate interstate commerce. Sometimes this policy has been successful, and sometimes it has not. After the Civil War, the development of the railroad industry was extremely rapid, and was marked by destructive competition and other abuses, such as local and personal discriminations, which made governmental regulation appear to be imperative. This regulation was eventually provided, as described in a previous chapter, and was readily justified as coming within the authority granted the federal government to regulate inter-

state commerce. The government has at times regulated labor conditions in the railroad industry, but in this matter it has not had a perfectly free hand. For example, in 1935, the Supreme Court voided the Railroad Retirement Act, which had been passed only a relatively short time before, providing for the retirement, with pay, of railroad employees after 30 years of service or after reaching the age of 65. It was held that matters relating purely to the social welfare of railroad workers lay outside the power of the government to regulate commerce, and that the effect of the Act was to take property from one group (the railroads) and give it to another (the employees) without due process of law.

The Regulation of Monopolies and Banking.—It was during the period of great economic development following the Civil War that the trust movement got under way. The federal government began to regulate the trusts in 1890 by passing the Sherman Anti-Trust Act, and continued with several other pieces of legislation which we have already examined. The anti-trust legislation has been considered constitutional under the power to regulate commerce, for the trusts have practically always done an interstate if not a national business, and could scarcely exercise monopoly power without restraining interstate commerce. The federal government has also passed many banking laws to strengthen our banking system and to eradicate banking abuses which have proved troublesome. This banking legislation, including the Federal Reserve Act and the laws of more recent years, is undoubtedly constitutional, because of the power of the federal government to regulate coinage and currency.

Public Utilities Regulation.—As we saw in the preceding chapter, the public utility industry has seemed to be a fit subject for governmental regulation. This regulation has been undertaken by the states, and has generally stood the test of constitutionality rather well, except when it was so arbitrary in character that it fell afoul of the clause of the federal Constitution which forbids a state to deprive any person of life, liberty, or property without due process of law. In 1935, the federal government attempted to invade the field of public utility legislation, but, while the constitutionality of the Public Utilities Act as a whole has not yet been determined, it appears possible that the Supreme Court will rule against this Act.

Labor Legislation.—The field of regulation in which both the federal and state governments have had least success is that

of labor legislation. The need for labor legislation was not foreseen by the framers of the Constitution; but, as our economic system developed and grew more and more complicated, the American workers became increasingly dependent upon the owners of land and capital for a chance to work, and progressively less able to determine the actual value of their services. Because of the pressing need of workers for continuous employment, and for other reasons dealt with in our chapter on industrial conflict, the bargaining power of labor is often insufficient to compel employers to pay adequate wages, maintain decent and safe working conditions, and limit the working day to a reasonable number of hours; and, at the same time, workers are able to provide for themselves little, if any, protection against the hazards of industrial illness, old age, and unemployment. Both federal and state governments have attempted to ameliorate these undesirable conditions, but usually with only slight success.

Minimum Wage Laws.—Minimum wage legislation represents an attempt to correct one of the conditions mentioned above, since it prohibits the employment of any person at a wage lower than an amount either stipulated in the law or left to the determination of a commission. While minimum wage laws are not always a blessing to labor, they can sometimes do a good deal for workers, and for employers as well, for they protect employers who have high standards against the unfair wage competition of unscrupulous competitors. However, minimum wage legislation has seldom stood the test of constitutionality. Some states have passed such laws, applying usually to women workers or to sweated industries, but the courts have ruled against them.

In 1918, the federal government passed minimum wage legislation affecting businesses in the District of Columbia, but the law was declared unconstitutional in 1923, on the ground that it was an unwarranted interference with the right of freedom of contract guaranteed to all individuals by the Constitution. Two recent cases help to show the uncertainty which surrounds this whole matter. Early in 1936, the Supreme Court voided the Guffey Coal Act, which provided, among other things, for the control of wages and labor conditions in the bituminous coal industry. The Court held that conditions of labor are always local conditions, and that the Constitution gives the federal government no power to control them. A few weeks later, the same Court voided the New York State Minimum Wage Law for women and chil-

dren, on the ground that it violated the "due process" clause of the Constitution, and held that a state has no power to pass legislation prohibiting, changing, or nullifying contracts between employers and adult women workers with respect to the amount of wages to be paid. Indeed, it was the majority opinion that neither state nor federal government had authority to fix wages for women workers.

In 1937, however, the Court reversed its decision on the minimum wage for women, by declaring the Washington State Minimum Wage Law constitutional. Said the Chief Justice: "The exploitation of a class of workers who are in an unequal position with respect to bargaining power and are thus relatively defenseless against the denial of a living wage is not only detrimental to their health and well-being but casts a direct burden for their support upon the community. What these workers lose in wages the taxpayers are called upon to pay. The bare cost of living must be met." Since both the New York and Washington cases were decided by five-to-four votes, it is evident that the views of one justice may determine the constitutionality or unconstitutionality of social legislation that affects millions of people.

Child Labor Legislation.—Another acute problem in the labor field is the use of child labor in industry. The employment of child labor in industry began many years ago, and has been increasing in recent years. While child labor may sometimes have adequate justification, the employment of young children for long hours in unhealthful conditions and at very low wages is most undesirable from both the individual and social points of view. It is likely to interfere with the education and mental and physical development of the children, to lower their moral standards, and to affect adversely the welfare of future generations. There is need for legislation establishing minimum ages for employment, minimum wages, maximum hours per day or week, and providing for the control of working conditions. Most states have some kind of legislation relating to children in industry, but it lacks uniformity as between states, often provides unsatisfactory standards, and almost always is poorly enforced.

In attempting to establish adequate standards for the United States as a whole, the federal government has passed four laws directly controlling the use of child labor, but none of this legislation has yet been approved by the Supreme Court. The first

of these laws, enacted in 1916, prohibited the movement in interstate and foreign commerce of goods produced in plants using child labor under conditions other than those prescribed by the law. This law was rejected by the Supreme Court as an attempt to regulate local industrial conditions by appearing to regulate interstate commerce, and as an unreasonable extension of the "commerce power." The second law, which was passed in 1919, levied a tax of 10 per cent on the net profits of businesses employing child labor under conditions other than those prescribed. This law was voided by the Supreme Court as a misuse of the taxing power of the federal government. In 1924, Congress passed a child labor amendment to the Constitution and submitted it to the states for ratification, but it has thus far failed to win the approval of a sufficient number of states. We must note, finally, that section of the Fair Labor Standards Act of 1938 which stipulates that no child under sixteen years of age may be employed in any industry engaged in producing goods that enter into interstate commerce, and that the minimum age shall be eighteen years if the work is "hazardous or unhealthy." The constitutionality of this law has not yet been tested.

Other Labor Legislation.—The regulation, by any governmental unit, of hours of labor for men is frowned upon by the Supreme Court as an interference with freedom of contract, except in cases when it can be shown that the public welfare is endangered by non-regulation. However, some of the states have regulated the hours of labor for women and children, and have provided mothers' pensions or allowed women to be absent from work with pay for a stated period before and after childbirth. The regulation of working conditions by the states has been successful from the constitutional point of view, and has helped to protect the health and safety of employees. The courts have held that governmental units have the right to limit hours of labor for all workers in the government employ, and for those engaged in the construction of public works. Recently, the federal government passed a law to regulate wages and working conditions in the businesses of firms which produce and sell goods to the government, but the constitutionality of this Act is still in doubt. Finally, in 1935, Congress passed the Social Security Act, which we have described in other chapters, for the purpose of making some provision against unemployment and old age dependency.

New Deal Legislation.—The post-1929 depression was so severe and so long drawn out that the Roosevelt administration, when it came into power in 1933, proceeded to pass many laws designed to regulate various phases of economic activity. Almost all of this legislation has been or will be reviewed by the Supreme Court. In addition to the laws which we have referred to above, we may mention specifically the Agricultural Adjustment Act, and the two Frazier-Lemke Acts, intended to aid the farmers in handling their mortgage obligations. It will be remembered that the Agricultural Adjustment Act was declared unconstitutional by the Supreme Court as an invasion of the rights of the states, since the Constitution had given the federal government no power to control agriculture, while the first Frazier-Lemke Act was voided as being in conflict with the "due process" clause of the Constitution. Among the laws to be reviewed by the Supreme Court, in addition to those previously mentioned, are the Securities Act of 1933 and the Securities Exchange Act of 1934.

We have been dealing thus far with the attempts of government to regulate the affairs of particular industries or lines of economic activity. In some cases, the federal regulation of economic matters was found to be in harmony with the federal Constitution, while in others it was not. Indeed, it seems safe to say that the constitutionality of any law dealing with a national economic problem must be regarded as extremely doubtful until it has been reviewed by the Supreme Court. This situation constitutes a very serious obstacle to the attempts of the government to solve serious economic problems through federal regulation. We must now turn from adventures in the regulation of particular industries to the recent attempt of the federal government to provide for the regulation of industry in general.

The National Industrial Recovery Act

Reasons for the Act.—One of the most interesting theoretical questions that can be asked about the post-1929 depression is whether this depression would eventually have cured itself if the administration had not undertaken to bring about recovery through governmental aid. Many people would answer in the affirmative, basing their opinion upon historical precedent. But, on the other hand, there were in 1932 many more who were convinced that recovery from the depression by a natural process would come but slowly, if at all, and only after great suffering and hardship to

the people of the country. They held that our debtor class was being rapidly ruined, and that unemployment would continue to increase and lead to disorders which would result eventually in the overthrow of our traditional, capitalistic system. Certainly, when the Roosevelt administration came into power in March, 1933, there was a widespread demand that the federal government do something to bring about general economic recovery.

Incidentally, this demand came largely from the business men themselves, who were later to be numbered among the severest critics of the recovery plan that was finally adopted for industry. These business men were anxious that the recovery plan should include a relaxation of the anti-trust laws. They urged that these laws were one cause of the depression, since they prevented the several enterprisers in an industry from coming together and agreeing on matters of production and price. With all enterprisers working in the dark, it was not surprising, they said, that industry should overexpand its productive capacity and rate of output —necessitating later a reduction in output, the unemployment of labor, and hard times for raw material producers, until readjustment might be achieved. If only the anti-trust laws were suspended, they suggested, the close cooperation of enterprisers in each industry would bring about a more accurate adjustment of production to demand and the stabilization of business activity. Thus, the business men thought themselves ready for economic planning—but planning only in the sense of a control of output, prices, and competitive methods, *by the enterprisers themselves* in each industry, under general governmental supervision.

Our business men complained bitterly that industrial recovery was being delayed by the use of unfair competitive methods in certain industries. If, for example, some business men sell at prices below cost of production, others have to adopt similar tactics, and such a condition is not favorable to an increase in industrial output or the reemployment of workers. Hence, said certain business leaders, the elimination of such unfair competitive methods would help to bring about recovery.

In response to pleas from many sources, Congress passed in 1933 the National Industrial Recovery Act. The Act declared it to be the policy of Congress to provide for the general welfare by promoting the organization of industry for the purpose of cooperative action among trade groups, to induce and maintain united action of labor and management under adequate govern-

mental sanctions and supervision, to eliminate unfair competitive practices, to promote the fullest possible utilization of the present productive capacities of industries, to avoid undue restriction (except as might be temporarily required), to increase the consumption of industrial and agricultural products by increasing purchasing power, to reduce and relieve unemployment, to improve standards of labor, and otherwise to rehabilitate industry, and to conserve natural resources.

The Methods Prescribed by the N.I.R.A.—The President was given full power to create any agencies necessary to effectuate the policies of the Act, and to appoint officers and employees, fixing their duties and compensation. Upon application by one or more trade or industrial associations or groups, the President was empowered to approve a "code of fair competition" for a trade or industry, if such associations or groups were truly representative of the industry, if they did not impose inequitable restrictions on membership, and if the codes were not designed to promote monopolies. All interested parties, including business men, labor, and consumers, were entitled to hearings before the codes were approved. The President was empowered to prescribe a code for any industry which did not itself submit one, and could impose additional tariff duties, or otherwise limit imports, if this were necessary to make the codes effective. A code, once approved, applied with the force of law to all members of a trade or industry, whether or not they had been parties to the code-making or had approved the finished code. A fine of $500 was to be imposed for each violation of a code, and each day that an offense continued was to be considered a separate violation.

The President was empowered to enter into or permit voluntary agreements among persons engaged in a trade or industry, through labor organizations and trade or industrial associations, if such agreements would aid in effectuating the policy of the Act. He could also require, temporarily, the licensing of business enterprisers in any trade or industry, in order to make such an agreement or code of fair competition effective. Finally, trade associations were required to furnish such information as the President might require.

Concessions to Business Men.—Under the operation of the codes, the business men in the various industries received the concessions which they had sought. Any activities of business men, which were legal according to the codes, agreements, and

licenses in effect under the Act, were exempted from the operation of the provisions of the anti-trust laws. Moreover, the business men, in drawing up the codes, were allowed to decide what should be considered fair and unfair competitive practices in each particular industry and to include their decisions in the codes. Since the codes, once approved, had the force of law, all business men in each industry were expected to be restrained in this way from engaging in unfair competitive practices.

Concessions by Business Men.—When the business men requested that concessions be made them by the government, they did not suggest that the government require anything of them in exchange. However, it was inconceivable that the government should extend these privileges to business men without asking something in return; and it was stipulated that every code of fair competition must contain satisfactory provisions with respect to three matters required by the government. In the first place, every code had to include provisions with regard to maximum hours, minimum wages, and other labor conditions which would meet with the approval of the President. Secondly, it had to contain a clause specifically permitting employees in the industry to organize and bargain collectively with their employers, and guaranteeing them freedom from coercion by the employers with respect to these activities. Finally, every code was required to prohibit the use of child labor in the industry, except under conditions provided by the Act.

The formulation and approval of codes under the Act went forward as fast as possible under the circumstances. Altogether, some 677 codes were approved for different industries, although some of the industries were hardly distinguishable from others. The industrial control scheme, however, was never put into full operation, for it was brought to an end in May, 1935, by a decision of the Supreme Court voiding the National Industrial Recovery Act. However, certain conclusions may be drawn from the limited operation of the National Recovery Administration.

The Wage and Hour Provisions.—The general conclusion is that the National Industrial Recovery Act did not operate very successfully, but we must attempt to see why this was true. First of all, the provisions of the codes relating to hours and wages did not produce the expected results. In many cases, the minimum wages were so low and the maximum hours so high as practically to maintain the *status quo*. The intention of these

provisions of the Act was not merely to share the existing amount of employment among a larger number of workers, but to increase employment while at the same time increasing the total wage bill of the industries and building up consumer purchasing power. Perhaps it was but natural that employers should try to minimize any such increase in their wage bills, and should sometimes evade the wage provisions of the codes by classifying large numbers of workers as learners or apprentices, or by paying the minimum wages and then requiring workers to return a portion of these wages in order to hold their jobs. And many employers fortified themselves against the effect of the codes by raising the prices of their products before coming under code jurisdiction, with the result that prices tended to rise faster than total wages, and consumer purchasing power did not experience the expected increase.

The Regimentation of Business Men.—Many business men were violently critical of the National Recovery Administration because, so they said, the government, through the codes of fair competition, was regimenting and controlling the everyday activities of business men. Most of this criticism of the government and the National Recovery Administration appears to us to have been misdirected. While the President had the power to prescribe a code of fair competition for any industry which did not submit one, he did not actually have to use this power because the various industries came forward with codes of their own. The business men not only drew up the codes, but also occupied a dominant position in the hearings which were conducted before the codes were adopted. The only concessions made to labor were those inspired by the fear of labor's power, while the interests of the consumers were in general disregarded, politely or otherwise. For all practical purposes, then, the business men wrote their own ideas into the codes, except for the minimum provisions required by the government.

Of these required provisions, the one which gave labor the right to organize was the only one which aroused very serious opposition. The criticisms by business men of such provisions as price-fixing, the regulation of output and hours of operation, and the control of the replacement of old capital goods and the introduction of new capital goods into the various industries were scarcely justifiable attacks upon the administration. For the National Recovery Administration did not insist upon the introduction of these features into the codes. Indeed, these restrictions were intro-

duced by the business men themselves who engaged in code-making. The most that the government could rightly be accused of was weakness in approving codes containing such provisions. If these features of the codes were objectionable, the business men who disliked them might better have directed their criticism at their fellow business men than at the government.

The Unfair Competitive Practices.—A similar statement is applicable to the provisions relating to unfair competitive practices. The administration left business men free to decide for themselves what should be considered fair and unfair competitive practices. However, when the leaders in a given industry got together for this purpose, they made the amazing discovery that there was but slight agreement among them in the matter of unfair and unethical competitive practices. Each seemed to regard his competitors' practices against him as unfair, and his own actions toward his competitors as quite ethical. Only by a process of compromise was it finally possible to draw up provisions relative to unfair practices in most industries, and these provisions were highly objectionable to a considerable number of concerns in each industry. Under the circumstances, it is difficult to see that the government was responsible for this unsatisfactory situation.

Code Violations.—Since most business men developed a highly unfavorable attitude toward the National Recovery Administration during the first few months of its operation, it is not surprising that there were many violations of the codes of fair competition. These violations went almost entirely unpunished. During its short life, the Recovery Administration had to devote practically all of its time to bringing the many branches of industry under the codes, and could undertake little in the way of their enforcement. The result was that the codes had become practically dead letters even before the final abandonment of the National Recovery Administration. It is not possible, then, to estimate the degree of success which might eventually have obtained in the administration and enforcement of the codes. But since there were nearly seven hundred codes, and since many of them had literally scores, if not hundreds, of provisions which might have been violated, it seems likely that the difficulties of enforcement would have been very great, and perhaps insuperable, in the absence of full and hearty cooperation on the part of business men.

Non-cooperation.—Though it has often been said that the N.R.A. failed to operate successfully, it might be more nearly accurate to say that it was never really tried. Economists knew, and said from the beginning, that the scheme could not hope to succeed unless the government received the active and loyal cooperation of business men. The plan provided not so much for governmental control of industry as for industrial self-control under governmental supervision, and it would seem that the business men in general lacked the degree of self-control necessary for its successful operation. It now appears that some of the business men who were loudest in their condemnation of the National Recovery Administration were the very ones who did most to make this experiment in industrial cooperation unworkable.

The Fostering of Monopoly.—As we noted in an earlier chapter, some of the provisions contained in certain codes facilitated the development of monopoly or trust powers in certain industries. Since the operation of the anti-trust laws was suspended with respect to activities under the codes, and since some of the codes contained provisions permitting the fixing of prices, the regulation of industrial output and hours of operation, and the replacement and introduction of capital goods, the business men, through their trade associations, were given both the opportunity and the incentive to restrict production and raise prices faster than wages. These results were, of course, the opposite of the original intent of the Act.

The Labor Provisions.—The National Industrial Recovery Act was criticized by many persons because it was constructed so speedily and carried out under such great pressure, and because at least some of the officials in charge apparently did not have a very clear idea of the purpose of the Act and the principles by which its provisions were to be carried out. It is probably true that a more satisfactory plan could have been developed over a longer period of time, but such a plan would have been of no assistance whatsoever in promoting business recovery in 1933, and probably would not have stood the test of constitutionality any better than the Act actually passed by Congress.

The National Industrial Recovery Act sought to remedy industrial ills, some of which have once more arisen to plague us. Business men do not relish our anti-trust laws now any more than in the past, but the government cannot cease its attempts to control the trusts, so long as industries remain in private hands. In-

deed, it is now seeking more effective methods for dealing with this problem. The question of limiting hours of work has come up again. We cannot go on indefinitely operating an economic system in which some men work long hours while others, though able and willing to work, find it impossible to get jobs. Moreover, though the end of the N.R.A. was doubtless welcome to many business men, its influence has been sadly missed by millions of children who are once more free to work long hours, for a mere pittance. Considerable progress was made under the N.R.A. in controlling this bad feature of our economic system, but it was said on good authority, within six months after the Supreme Court decision against the N.R.A., that child labor conditions were worse than they had been before the passage of the Act, and were steadily growing still worse.

The Demise of the N.R.A.—The N.R.A. came to an end in May, 1935, by a decision rendered by the Supreme Court. The Act was found defective in two main respects. First, it was held that in this Act Congress had improperly delegated its legislative powers to the executive department of the government, by giving the President unduly wide and sweeping powers in setting up codes of fair competition and in formulating policies in general. Of course, Congress is permitted to delegate powers to the executive, but such grants must be definite and carefully circumscribed. While the N.R.A. legislation did turn over unprecedented peace-time powers to the executive, it is difficult to see how Congress itself could have undertaken to formulate the codes or to prescribe exactly what provisions should be in the code of each industry.

Secondly, it was held that Congress in this Act did not restrict itself to the control of interstate commerce. The Act was passed upon by the Supreme Court in connection with a case arising out of a concern's dealing in chickens in violation of the poultry code. The firm in question purchased chickens which were raised in other states, and had them shipped to New York City where it marketed them in a way which failed to comply with certain terms of the code governing the poultry business. The Supreme Court held that the power of the federal government was limited to interstate commerce and other activities which directly affect such commerce, and that the business of this firm did not affect interstate commerce directly. The Court held that the govern-

ment's regulating powers could not be set forth in a general statement, but would have to be decided by the Court in each case.

In this poultry case, the Supreme Court interpreted very narrowly the federal government's power to regulate interstate commerce, limiting this power to the right to control only the actual movement of goods between states. According to a strict interpretation of this kind, the transportation of chickens from outside states to New York City would be interstate commerce, but a dealer who had chickens shipped to him in New York City from outside states and later sold them in that city would not be engaging in interstate commerce—nor could his activities be said to affect such commerce directly. Though it is obviously desirable that the federal government should be restrained from controlling every phase of economic activity under the guise of regulating interstate commerce, it seems equally important that the Supreme Court should avoid the opposite extreme. For it is certainly undesirable that the Court should imply that interstate commerce is being transacted only at the instant of time when economic goods are actually crossing state lines.

Recent Examples of Governmental Control

The National Labor Relations Act Decision.—Since the N.R.A. decision, and particularly following President Roosevelt's campaign for the enlargement of the Supreme Court, this Court has come to interpret somewhat more liberally the federal government's power to regulate interstate commerce. The decision on the National Labor Relations Act is an outstanding example of the new attitude. This Act, which has been described more fully in another chapter, guaranteed to workers the right to organize and bargain collectively with their employers, and prohibited employers from engaging in unfair labor practices. The Act was to apply, of course, only to businesses engaging in interstate commerce, and for this reason the question of the nature of such commerce arose once more.

In April, 1937, the Supreme Court decided several cases which had arisen under the National Labor Relations Act. In upholding the Act, the Court abandoned the notion that the power of the federal government to regulate matters that concern employer-employee relations is confined to interstate transactions, and to other activities directly connected with buying and selling across state lines. It held that Congress has the power, under the Consti-

tution, to prohibit acts that tend to cause labor disputes in manufacturing, if the manufacturing activities are so closely related to the movement of raw materials and finished products in interstate commerce, that the curtailment of manufacturing operations by labor disputes would interrupt or obstruct such commerce. Under this interpretation of the commerce clause, it was decided that even the operations of an important steel manufacturing concern were subject to the provisions of the Act. Whether this liberal attitude will be maintained in the future is a question of considerable importance.

The Fair Labor Standards Act of 1938.—After the demise of the N.R.A., the administration manifested a desire that Congress pass a general act regulating wages and hours of work in the United States. Several attempts to enact such a law resulted in failure, but finally in 1938 the Fair Labor Standards Act, popularly known as the Wages and Hours Act, was passed. This Act has been dealt with in another chapter, so that we shall describe it only briefly at this point. It provides for a minimum wage of 40 cents an hour and a maximum working week of 40 hours in interstate industry. These levels are to be attained within a seven-year period. For the first year, minimum wages of 25 cents an hour, rising to 30 cents in the second year, and a maximum of 44 hours a week, dropping to 42 hours in the second year, were provided. The Act will be administered by a single administrator, who will appoint in each of the various industries boards which will represent management, labor, and consumers. These boards will decide, in their respective industries, the rate at which progress shall be made toward the seven-year goals, and will recommend exemptions from the wage and hour standards in certain industries and areas, if such action seems desirable.

Certain lines of economic activity are exempted automatically from the operation of the Act, and it is difficult at present to say just how many workers will be affected by it. There is a fairly widespread impression that the Act will prove to be constitutional. If so, this piece of legislation, in combination with the National Labor Relations Act, will apparently advance the legal status of labor to a position beyond that enjoyed under the N.R.A.

Economic Planning and the Constitution

During the depression years that followed 1929, there was much talk in the United States about economic planning as a means of

avoiding depressions and insuring business stability. Our knowledge of the difficulties encountered by the federal government in attempting to regulate economic activity makes it possible to draw a conclusion as to the feasibility of economic planning. Such planning, in any real sense, involves setting up a central board or commission to direct the economic affairs of the country; and this board must have the power to control prices, labor conditions, industrial output, extensions and reductions in productive capacity, and other matters. The federal government, under our Constitution, is not given power over such matters, and could control them only under a very liberal interpretation of the grant of power to regulate interstate commerce. Though the Supreme Court is apparently becoming more liberal in its interpretation of this power, it is unthinkable that it would broaden this interpretation sufficiently to permit genuine economic planning. Moreover, if the delegation of power by Congress in connection with the N.R.A. was unconstitutional, economic planning under our Constitution would seem to be impossible, for it would involve a delegation of powers far in excess of all those granted to the executive department in the depression emergency of 1933.

Economic Planning and Socialization.—But this is not quite the end of the story. Most economists agree that economic planning, except in the half-hearted sense of planning by individual industries, is impossible unless the federal government itself owns all the non-human resources of production. That is, all land and capital must be socialized if national economic planning is to be effective. So long as these factors of production are privately owned, a central board might undertake to plan, but it would lack authority to compel enterprisers to carry out its plans. For effective planning, the planning board must be able to determine the uses to be made of existing land and capital, the goods to be produced, and the quantities of each good. It must be able to decide how much of the current national income shall be devoted to satisfying the present wants of consumers, how much shall be used for creating capital goods which will enhance the output of consumers' goods in the future, and how the new capital is to be apportioned among the various industries of the country. It must be able to determine the prices of all kinds of economic goods and the amount of purchasing power to be distributed to the citizens, so that the products of industry may be taken from the market, and so, also, that the income paid to workers in different occupa-

tions will insure the distribution of the labor supply among industries and occupations in the manner desired by the planning board. It must be able to take surplus income from one industry to make up a deficit in another, or to create new productive facilities of a different kind. It is difficult to see how these functions could be performed by a planning board while leaving to individuals any semblance of present private property rights in the material resources of production.

Some people are still hopeful of attaining some measure of economic planning by allowing each industry to plan its own affairs under our existing capitalistic system, but their hopes appear to us to be without foundation. So long as private individuals own and control the means of production and receive an income which varies according to the ways in which these means are used, we may expect productive agents to be used in the ways which appear most profitable to their owners. In other words, the conflict between individual and social interests, which is frequently noted as a characteristic of our present economic system, would continue to exist. We should expect private individuals to continue to place their own interests first, and to disregard largely the interests of society. Each industry would plan its affairs in such a way as to maximize gains for itself, and the total result would be something very different from the maximum of welfare for society as a whole. So long as the agents of production continue to be sources of private gain to individuals, we cannot reasonably expect them to be used in the ways which will contribute most to social welfare. And it is scarcely necessary to say that the socialization of land and capital is hardly conceivable under our existing constitutional set-up.

Since effective national economic planning is, in our opinion, dependent upon the existence of a socialistic economic system, we shall not consider the matter further at this point. In the next two chapters, we shall look into the principles and practices of socialism and communism. And after examining economic planning as it is conducted in Soviet Russia, we shall be in a better position than now to estimate the feasibility and probable effectiveness of something of this kind for other countries.

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1. Explain the variations in the opinions of different individuals as to the proper relationship between government and industry.

2. What relationship existed between government and economic activity in England prior to the Industrial Revolution?
3. What is meant by *laissez faire*?
4. Why did the attitude of *laissez faire* predominate during the early years of this country?
5. How did this attitude affect the character of our federal Constitution?
6. Why was the *laissez-faire* system successful for many years in this country?
7. Why has our federal government, in recent years, been moved to interfere with economic activity?
8. Explain the function of the Supreme Court in passing on the constitutionality of legislation.
9. Why has the regulation of monopolies, banking, the railroads, and the public utilities generally been considered constitutional?
10. What has been the experience of our federal and state governments with respect to minimum wage laws under the Constitution?
11. What has been the experience of the various governmental units with respect to child labor legislation?
12. Why has the question of the constitutionality of legislation become increasingly important in recent years?
13. Why did Congress enact the National Industrial Recovery Act in 1933?
14. Explain the method of operation of the N.R.A.
15. What concessions were made to and required from business men under the N.R.A.?
16. How successful were the wage and hours of work provisions of the codes of fair competition? Explain.
17. Did the federal government seek to regiment business men through the codes of fair competition? Explain.
18. Explain the problem of enforcing the codes of fair competition under the N.R.A.
19. Why was the N.R.A. said to foster industrial monopoly?
20. What were some of the good points of the N.R.A.?
21. Why was the N.R.A. held unconstitutional by the Supreme Court? Explain fully.
22. What changes have been taking place in recent years in the attitude of the Supreme Court toward the power of the federal government to regulate interstate commerce?
23. "Congress has recently enacted labor legislation which puts back into operation some of the labor provisions of the N.R.A." Explain.
24. Is effective economic planning possible under our federal Constitution? Why or why not?

25. Is effective economic planning possible under the capitalistic type of economic system? Why or why not?

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PROBLEMS OF COLLECTIVISM AND FASCISM

24 SOCIALISM AND COMMUNISM

MANY PEOPLE FEEL THAT IT IS USELESS TO ATTEMPT, AS WE HAVE DONE, TO DEAL WITH ECONOMIC MALADJUSTMENTS SUCH as the trust problem and the railroad problem as separate and distinct matters susceptible of solution without reference to other problems. To these people it appears that such problems are merely symptoms which indicate that our competitive, capitalistic, economic system is already, or is rapidly becoming, unworkable. If this is true, the attempt to treat these symptoms individually is doomed to failure. Those who hold this view, whom we call collectivists, believe that our traditional economic system should be abandoned and a new type of system substituted for it. Since, as we saw in the preceding chapter, a system of national economic planning could scarcely be successful in the absence of important changes in the nature of our economic system, we shall examine in some detail the principles, and the outstanding points of strength and weakness, of two of the principal types of collectivism.

Collectivism in General

The Characteristics of Collectivism.—Before considering socialism and communism as specific types of collectivism, we may list the characteristics which seem to be common to all types of collectivism. They are, according to one writer: "First, a condemnation of the existing political and social order as unjust; second, an advocacy of a new order consistent with moral values; third, a belief that this ideal is realizable; fourth, a conviction that the immorality of the established order is traceable not to a fixed world order or to the unchanging nature of man but to corrupt institutions; fifth, a program of action leading to the ideal through a fundamental remolding of human nature, or of institutions, or both; and, sixth, a revolutionary will to carry out this program."[1]

[1] Oscar Jaszi, in *Encyclopaedia of the Social Sciences*, New York, The Macmillan Company, 1935, vol. 14, p. 188

The Condemnation of Capitalism—Distribution.—In their indictment of our present economic system, the supporters of collectivism achieve a high degree of accord. To them, one of the most objectionable features of the present system is the existing inequality in the distribution of wealth and income. We have commented, in earlier chapters, upon the evils which result from economic inequality. It leads to the misdirection of production by consumers, and prevents the maximization of want-satisfaction from the goods which our system produces. It leads to inequality before the law, and inequality in influencing legislation and in political activities generally. It may also be an important factor contributing to business depressions. The collectivists are quite dismayed by the misery, suffering, vice and crime which exist in the low-income groups, and by the luxury, waste, and extravagance indulged in by those with huge incomes. They object not merely to the extent and effects of inequality, but also to the way in which the inequality in income distribution comes about. They bemoan the fact that most people under our economic system must work long and hard for a miserable pittance, while a comparatively few favored individuals, through their ownership of land and capital, enjoy handsome incomes, often without lifting a hand in work of any kind. They condemn private property in land and capital, and believe that incomes should be paid solely on the basis of personal services rendered in production.

The Ineffectiveness of Production.—Quite apart from their attacks upon present-day distribution, the collectivists have much to say about the wastefulness and ineffectiveness of capitalistic production. It is charged that there is much waste through competitive duplication of productive facilities and human labor. Collectivists delight in describing, as examples of this waste, competing gasoline service stations which often occupy three, and sometimes all four, corners of busy intersections, although they sell products which are highly similar; and the half-dozen milk wagons of different companies which patrol a given city street, each serving a few consumers with dairy products which are substantially the same. Considerable waste of human and material resources also results from competitive advertising and salesmanship, which often lead merely to the transfer of customers from one competing company to another without serving any genuinely useful social purpose. Operating under the influence of self-interest and freedom of enterprise, business men, in selecting a line of

production, are much more likely to consider the possibility of profits for themselves than the welfare of society. Hence, as the collectivists point out, productive resources are wasted in turning out trivial, useless, or even harmful products, while important human wants are left unsatisfied.

The Breakdowns of Capitalism.—Not only is the capitalistic economic system said to be wasteful and inefficient when it operates, but it is subject to periodic breakdowns, commonly called depressions, with economic activity at low ebb, though human wants are far from being satisfied. Although some of the conditions leading to depressions might be corrected without destroying the system, the collectivists feel that these depressions can never be completely eliminated under capitalism, for they hold that depressions are inherent in the very nature of a capitalistic system. Economic activity under capitalism is said to be chaotic and planless. The individual is left relatively free to produce what he chooses, when he chooses, and as much as he chooses, without reference to what other producers are doing or the public need for the product. With hundreds or thousands of producers operating in this fashion in an industry, there is little chance that exactly the proper amount of a good will be turned out year after year, or that the output of one industry will be properly adjusted to that of others. Periodic maladjustments and breakdowns appear to be unavoidable in such a system.

Moreover, the collectivists commonly hold that in a capitalistic system there is bound to be conflict between individual and social interests. It is to the interest of society to have every economic good produced in abundance until consumers' desires for the good are completely satisfied; but it is often to the interest of producers to restrict production, raise prices, and even to gain monopoly control for the purpose of increasing profits. Profit for society can result only from abundance, but profit for given producers comes often from scarcity and high prices; for, if a producer can make his product relatively scarce, he can often command more of other products in exchange than he could secure by maximizing his own output. Thus, in a capitalistic system, the interests of society may suffer.

This conflict between individual and social interests manifests itself especially clearly after a long period of prosperity, marked by increasing production and rising prices. As the period of prosperity continues, some enterprisers appreciate the fact that

it will be impossible to keep on producing increasingly larger quantities of goods and selling them at steadily rising prices. Hence, they begin to retrench in anticipation of a period of poor business. They lay off some workers, or put them on part time, and cut down their purchases of materials and supplies. Thus they reduce the purchasing power of laborers, farmers, and others, and the business of enterprisers in general falls off. They, in turn, react by further restriction of production and discharge of workers, and finally the business depression arrives in earnest. It should be noted that it is not to society's interest to have production restricted at such times. Consumers' wants for various kinds of economic goods have not declined. Society as a whole wants and needs to have production continued, or even increased, but private enterprisers, owning land and capital and faced with the actual or prospective disappearance of their profits, follow their own self-interest and retrench. In trying to protect their own interests, enterprisers may in this way do society a very ill turn. The collectivists contend that if society owned the land and capital and if business men worked for society for wages instead of profit, the situation would be vastly improved.

The Doctrines of Karl Marx.—A considerable difference of opinion has existed among collectivists as to when and how collectivism will arrive. In some quarters, collectivism is regarded as an ideal future state, to be attained only through extensive preparation and hard work. On the other hand, collectivism was regarded by Karl Marx and his followers as a system which will inevitably evolve out of capitalism, and which is already on the way whether most people realize it or not. The doctrines of Marx have had such a profound influence upon the advocates of collectivism that we must examine them briefly.

The Economic Interpretation of History and the Class Struggle.—Karl Marx held that economic matters are dominant in determining the course of history and that the form of government, family system, moral standards, and literature of a society are but reflections or by-products of economic activities and institutions. An important feature of capitalism, according to Marx, is the continuous class struggle. The two opposing classes are called by different names at different times in history, he said, but the struggle goes on all the time. The class struggle at present is supposed to be between the capitalist (or owning) class and the proletariat (or working) class.

Value and Surplus Value.—Prominent among Marx's theories were those relating to value and what he termed "surplus value." He held that all commodities, regardless of differences in size, shape, composition and usefulness, contain a certain common element, that is, the labor used in producing them. Capital, though useful in production, he regarded merely as past labor congealed in a permanent form. The values of commodities in terms of each other depend upon the amount of socially necessary labor contained in them. For example, a commodity that takes twice as much socially necessary labor to produce as another commodity should have twice as much exchange value.

From this theory of value, Marx derived his explanation of the method by which workers are exploited by capitalists. Under capitalism, the workers cannot work for themselves because they are unable to acquire the land and capital needed in production. Consequently, they must work for the capitalists who own these material means of production. As a condition of employment, the workers must turn their products over to the capitalists who are free to sell them for whatever they will bring, which will be an amount proportionate to the labor contained in the products. On the other hand, the wages which the capitalists pay to the workers need only be high enough to maintain the laborers and their families, and to permit them to raise enough children to take their places. The difference between the value created by the workers in production and the wages paid to them is called "surplus value," and goes to the capitalists as an unearned increment. The workers cannot refuse to make this bad bargain, because they are dependent upon the capitalists for a chance to work and because in a capitalistic system there is always a reserve of unused laborers waiting to take the places of those already employed. In this exploitation of the workers and appropriation of surplus value by the capitalists lies the cause of the class struggle.

The Concentration of Capital and Expropriation of the Capitalists.—According to Marx, the thirst of the capitalists for gain is so great that they seize every possible opportunity to increase the amount of the surplus value. This leads to increasing misery and suffering among the workers and to the formation of an ever larger labor reserve. Moreover, it brings about an increasing concentration of capital in the hands of a few individuals; for the large enterprisers are more efficient than the small ones, and force the latter out of business, taking over their land and

capital. As this process goes on, society will become more and more the victim of commercial crises or depressions until finally will come that last crisis in which the proletariat will rise up, dethrone the capitalists, and operate the material means of production in their own interests. Eventually will come a classless order in which all workers will share the income of society and the state will dwindle away—for Marx regarded the bourgeois state as an instrument for protecting the owning class in its favored position.

Criticisms of the Marxian Theories.—Marx wrote three large volumes to elucidate and elaborate his theories, and many books of criticism of his theories have appeared since his time. However, we shall be able here merely to suggest why his theories have been very largely discredited. First of all, the idea that all of man's activities can be explained in terms of the economic activities and institutions is based upon an overemphasis of the economic aspects of life. History must certainly take economic matters into account, but there are many human actions which cannot be explained wholly on economic grounds. As for the class struggle, it is obvious that there are differences between capital and labor and that their relations might be loosely termed a struggle. However, this struggle is not the only, or necessarily the most important, feature of the capitalistic system. Marx, thinking of the proletariat as an ideal theoretical class, attributed to the workers a unity of purpose and action which they do not possess. Workers have varied interests, many of which are not economic in character. Moreover, there is little reason to suppose that workers always act in accordance with their economic interests, to the exclusion of interests of other kinds. It must also be remembered that there are economic differences between different classes of labor, and these differences *in degree* may sometimes be quite as important as the difference *in kind* that exists between capitalists and laborers

The Marxian theory of value has also been sharply and successfully attacked. According to Marx, the only element common to things which have exchange value is the labor contained in them. This contention led him to say that articles of wealth which have not been produced by human labor have *use value*, but not *exchange value*. However, as we know, natural resources which are in no sense the product of human labor, have exchange value just as truly as have the economic goods produced by human

labor. Marx never demonstrated that the value of a commodity depends upon the amount of labor contained in it. He merely attempted to show that there could be no other element common to different commodities—and this is by no means the same thing. Marx also overlooked the element of utility in connection with exchange value. His analysis of value was incomplete in that it approached the question of value entirely from the side of supply. For it should be clear that utility is an element common to all goods which have exchange value, and an element which plays an important rôle in the actual pricing of commodities in our economic system.

The theory of surplus value, also, has fared badly since Marx's time. In explaining surplus value, Marx divided capital into two parts. He said that constant capital (which we would today call fixed capital) consists of such things as machinery and buildings, and is not a source of gain to the capitalist, since this capital merely reproduces itself in the value of the things produced. He regarded variable capital, used to pay wages, as the source of the surplus value and the gain of the capitalists. But if, as Marx thought, all gain to the capitalists comes from variable capital and not from constant capital, it is difficult to understand why capitalists should introduce machinery into their industries or make use of increasing amounts of fixed capital. For the greater the quantity of fixed capital goods used, the less would be the gains in the form of further surplus value. The rate of gain to capitalists would be highest in industries using much labor and little fixed capital, and lowest in industries using little labor and much capital; and yet Marx's prediction of revolution was based upon the growth of a great army of unemployed labor, which supposedly was to result from an increasing use of labor-saving machinery.

In describing the return received by the capitalists as a surplus value filched from the laborers, Marx overlooked the element of time and the important function of waiting performed by those who save and thus make possible the formation of capital. He also largely disregarded the important administrative and managerial functions which are often performed by capitalists. Finally, he failed to explain why the capitalists, under competition—since they were making a large gain from each worker used—did not bid against one another in the attempt to hire more of these profitable laborers, until they reached the point at which the contribu-

tion of the marginal worker to production equaled, and only just equaled, the wages which had to be paid to get his services.

It would seem that Marx was but an indifferent prophet, if we may judge by subsequent events. The population has not become divided into two distinct classes, capitalist and proletariat, as he predicted it would. Instead a large middle class has continued to exist. Under the development of the corporation and industrial combinations, there has been considerable concentration of capital, but it has been a concentration of control over capital rather than of the ownership of capital which was so prominent in the Marxian analysis. The lot of the workers has not been one of increasing degradation, misery, and squalor since Marx's time. It is true, of course, that for some years following the Industrial Revolution the trend in the condition of the working class seemed to be in that direction; but labor organization and governmental intervention in the form of labor legislation and social insurance—developments which Marx, of course, could not foresee—have helped to reverse this trend. For some years we have had a reserve of idle labor and this reserve has been large in times of severe depression, but it has not reached the proportions predicted by Marx, nor is it clear that this reserve is an inevitable feature of the capitalistic system. And the time when all material means of production will be owned by a few, and the rest of the population (the proletariat) will rise up in its might and destroy these few capitalists, does not indeed appear to be imminent.[2]

The Elements of Socialism and Communism

Having described briefly the indictment which collectivists bring against the capitalistic system and their basis for hoping that it will be replaced by a different type of economic order, we now turn to a consideration of the characteristic features of socialism and communism. The terms "socialism" and "socialistic," like the word "inflation," are very loosely used in everyday conversation. Some people regard as socialistic every extension of governmental functions, even though the new functions are calculated to uphold and strengthen the existing order and thus lessen the probability of the adoption of a different type

[2] For a brief but searching analysis and criticism of the doctrines of Karl Marx, the student may well read Alexander Gray, *The Development of Economic Doctrine,* New York, Longmans, Green & Company, 1931, pp. 293-329 This work has been helpful in the preparation of this brief summary of the theories of Marx.

of system. Some, indeed, are inclined to view as socialistic any governmental activity, old or new, which apparently does not serve their own particular interests, and to stamp as a socialist any person whose views on economic matters differ from their own. The term socialism, to us, means an economic system in which the material (that is, non-human) means of production are owned and managed by society. Communism includes all of this and a good deal more. For under communism consumers' goods would be collectively owned and arbitrarily distributed among the populace, in addition to land and capital being owned and operated collectively.

The Collective Ownership of Land and Capital.—Under both socialism and communism, then, the material means of production—that is, land and capital—would in general be owned by society and not by private individuals. But this does not necessarily mean that all land and capital would be owned by society. Individuals might be allowed to own plots of land as home sites, and even to own the land and capital needed in the operation of small business enterprises, such as shoe-repair shops and corner stores. Some socialists question that it would be wise for society to try to own and operate the land and capital used in agriculture, which is so largely a decentralized industry. Individuals would certainly be allowed to own such goods as lawn mowers and washing machines with which to perform services for themselves; and it would be exceedingly difficult to prevent people from performing similar services for others for pay, or from hiring these goods to others on a rental basis. An insistence on the complete and absolute ownership of land and capital by society would probably weaken, rather than strengthen, the socialist position. However, the essential fact remains that, under socialism, the land and capital used in all major industries, with the possible exception of agriculture, would be owned by society, and private individuals would no longer receive rent and interest for the use of these productive agents.

Opinions differ as to the method by which land and capital would be brought under the ownership of society. It is sometimes suggested that the present owners should be expropriated by violence and revolution. In general, it is probable that communists incline more strongly toward this point of view than do socialists Many people realize, however, that such measures, while they would bring quick and thorough results, are subject to grave

dangers. They are likely to repel all who are motivated by humanitarianism. Moreover, to cut down ruthlessly the present owners of land and capital would deprive society of some of its most capable executives and administrators. And if revolution were attempted but failed, society might well swing to the opposite extreme so that collectivism would be impossible for many years to come; but a failure to achieve collectivism by democratic processes at any one time might be followed by success a little later. Finally, if revolution resulted in a stoppage or breakdown of economic activities for any considerable period of time, an indescribable amount of suffering and loss of life would almost certainly result.

For these and other reasons, it seems that socialism, if it is to come, should await the time when a sufficient number of citizens appreciate its merits so that it can be voted into existence. But, in any event, if the land and capital are to be acquired by society, there will remain the question of whether confiscation or purchase is the better method of procedure. In general, purchase appears to be sounder than confiscation. Of course, the compensation of present owners would perpetuate, for a time, the great inequalities in wealth and income to which socialists object so strenuously. However, since the lump sums or annuities which might be granted to the present owners would not be transferable to their heirs, this problem would be a temporary one.

The Collective Management of Land and Capital.—Opinions differ, also, as to the best way to manage the socially owned industries. Some collectivists think that the central government should assume direct responsibility for the management and operation of all of the socialized industries. Others hold that management should be vested in trade unions, syndicates, or even in modern replicas of the medieval guilds. In any case, the central government would have to supervise in general the operation of the entire economic system, for there are some functions which could hardly be performed by any agency other than the central government.

Such duties would probably be performed by a governmental commission, or commissions. It would be necessary for the central agency to collect and study a great mass of statistical information relating to natural resources and other factors of production, to the wants of consumers for different kinds of economic goods, and to the extent to which these wants are

currently being satisfied. This agency would have to make decisions, based upon the expressed will of the people, as to which industries should continue to operate and which, if any, should pass out of existence. It would have to decide how much of each industry's product should be made in each period, and coordinate the production of the different industries of the country so that the national income as a whole would meet the needs of this socialized people.

The Distribution of Income.—An important problem under socialism or communism, as under capitalism, would be the distribution of the national income. Should economic goods be distributed directly among the citizens or should the members of society be given money incomes with which to buy such goods as are available? The communists believe in the collective ownership of consumers' goods, as well as capital and land, and would have these goods distributed directly among the people. Socialists, on the other hand, are more kindly disposed toward the use of money and the exercise of choice on the part of consumers.

Once the *method* of distribution has been decided, it becomes necessary to formulate a *principle* of distribution. Shall the national income be divided equally among the income-receiving citizens or shall there be differences in incomes, and if there are to be differences upon what basis shall the differentiation be made and to what extent? Some socialists contend that all should share alike, although it is not always clear whether this means an equal share for every man, woman and child or equal shares as between families. Sharing equally would probably mean, to these socialists, the equal sharing of money income, while real income would vary in composition from one individual or family to another. Many socialists recognize the difficulties of getting people to work hard, or to take the more responsible and important positions in our economic system, if all persons are to have equal incomes; and consequently they advocate that there be some variations in income as between individuals, based upon differences in ability, or efficiency, or both. However, most communists, and some socialists, hold out for an entirely different principle of distribution, urging that individuals should contribute to production on the basis of their ability and receive income on the basis of their needs. This might mean that those who contributed most heavily to production would draw the smallest incomes because their needs were slight In general, we may consider the

principles of equal distribution and of distribution according to needs, as ideals rather than practical proposals. In practice, a socialistic or communistic economic system would probably have to tolerate an unequal distribution of income based upon the productivity of its citizens.

One thing seems certain, however. The degree of economic inequality which would exist would be very small as compared with that which we have today. Since society would own the land and capital, private individuals would not receive, under socialism or communism, any incomes from rent and interest. Of course, different pieces of land would vary in productivity under collectivism as under capitalism, but the fruits of these variations in productivity would be spread over society as a whole, whereas now they go to a relatively small group of landowners. Similarly, a collectivist society could not do without capital goods, but these goods would be furnished by society as a whole and the rewards for saving and waiting would be reaped by society as a whole. Since industries would be run by society, the enterprisers and managers would be servants of the state and would be paid a stipulated wage; they would not, of course, receive any income in the form of profits as at present. All income would be distributed in the form of wages, except that provision would have to be made, in some way or other, for those who were unable to contribute to production. While differences in income would probably be permitted on the basis of efficiency and ability, we may be quite sure that even the most important executives and managers would not draw incomes of $100,000 to $1,000,000 a year as some do at the present time. But wages *in general* would, under socialism or communism, be considerably higher than at the present time; for every worker would have included in his wage his share of social rent and interest, in addition to the payment made for his labor.

Saving and Capital Formation.—While socialism or communism would eliminate most competition, as we now know it, and would greatly limit the institution of private property, we must not assume that either form of collectivism would turn its back upon all features of a modern capitalistic economic system. Production would doubtless continue to be roundabout, large scale, and specialized in character, and would require large and increasing amounts of capital. Since collectivists frown on

the receipt of interest by private individuals, the question may be asked as to how the necessary capital would be provided.

Capital formation, it will be recalled, depends upon saving. Under our present system, certain individuals must refrain from consuming to some extent, and must, in effect, elect to buy capital goods instead of consumers' goods with a part of their money incomes, if capital formation is to take place. In other words, in any society, the cost of obtaining capital goods, which will help to create a more abundant life in the future, is found in the necessity of getting along with a smaller quantity of consumable products at present than could have been obtained if the creation of capital goods had not been undertaken. In a collectivistic society, decisions as to how much to save would not be left, as at present, to private individuals motivated by the prospects of interest. Instead, the central authority would decide how much should be saved, and would carry out its decision by directing the use of a certain part of society's land and capital into the production of capital goods rather than consumers' goods. In this way, all the people would help to bear the cost of providing capital goods by having to put up with smaller real incomes currently than they would otherwise have received; and later on, when society's productivity had been enhanced by the use of this capital, presumably all would share in the greater national income.

Money and the Price System.—Another pertinent question has to do with the extent to which a socialistic or communistic economic system would make use of money and the price system. Under communism it may be assumed that money and prices would not be used. Consumers' goods, when produced, would belong to society, as well as land and capital, and the consumers' goods would be distributed directly among the people in some arbitrary fashion, so that money and prices would not be needed. Labor would have to be directed arbitrarily into the proper occupations, unless we may assume that the better nature of men would cause them, under communism, to select the occupations in which they would be most useful to society. Similarly, society as a whole, through its representatives directing the system, would have to decide what goods should be produced, and in what quantities.

While some socialists have favored the use of labor certificates or similar substitutes for money, most socialists are at present

resigned to the use of money and to some dependence upon prices. For one thing, prices would probably be used under socialism to direct the labor supply into the desired occupations. Land and capital, being owned by society, could be arbitrarily distributed among different industries and occupations without any great harm being done. The labor supply, however, is made up of human beings who have feelings, home ties, and other associations which would make it undesirable for the central authority to shunt them from one occupation to another and from one part of the country to another in an arbitrary fashion. Consequently, socialism would probably rely upon differential wages, as far as possible, to get labor to move from one industry to another and from one locality to another in order to keep the labor supply distributed in accordance with the changing needs of society. Thus, if more workers were needed in baking bread and fewer in producing motion pictures, the wages of bakers would be raised and those of motion picture workers lowered, until workers had shifted from one occupation to the other in desired numbers, or at least trained their children to become bakers rather than actors, directors, or cinematographers.

A socialistic system would probably also depend upon prices, to a considerable extent, to get the products of industry rationed among the people as consumers. The use of prices is probably the best way to allow consumers to choose what they will consume and to permit a variation in the composition of real income as between individuals. Since society would control both the total amount of money to be given to citizens and the prices at which products would sell, it should be quite possible to distribute the output of industry among the people while giving them considerable freedom of choice. The total amount of want satisfaction derived from the national income would probably be much greater, with the use of prices and the exercise of freedom of choice, than it would be if goods were rationed directly to the consumers in certain fixed quantities.

However, a socialistic system would not rely so extensively as a capitalistic system upon prices. We have already seen that socialism would not depend upon prices to govern the total amount of saving and investment, or the distribution of land and capital goods among the several industries. Moreover, it would not allow prices to determine what to produce and in what quantities. The fundamental relationship now existing

between prices and costs of production, under competitive conditions, would largely disappear under socialism. Since land and capital would be owned by society, any charges made to industries for the use of these agents would be purely arbitrary. Wages would be determined by the central authority as would also the prices of finished products. Under these conditions, there would be no necessary relationship between prices and costs of production.

Let us suppose, for example, that an article produced under socialism did not, at a price equal to "cost of production," sell in the quantity in which it was being produced. Under capitalism this situation would be expected to lead eventually to a restriction of the productive capacity of the industry and a consequent reduction of output. Under socialism the output might be maintained or even increased if the central authority thought the commodity should be widely consumed by the people. Any "loss" on this article could be covered by selling other, less essential goods at prices higher than their alleged cost of production. Similarly, the ability to charge a price higher than cost of production for an article provides, under capitalism, an incentive to increase productive capacity and output, but this would not be true under socialism. Capacity and output would be expanded only if this course of action appeared socially desirable for other reasons. Prices and costs under socialism would be used merely as bookkeeping devices to aid in planning production to meet the needs of the people, and in checking up on the degree of efficiency with which plans were carried out. They would be purely arbitrary amounts, as determined by the central authority. The price system, thus administered by the peoples' representatives, would be the servant of society and not its master.

Possible Accomplishments of Collectivism

The Wastes of Competition.—Such are the features which would probably characterize a collectivistic economic system. We must now attempt to see what gains the collectivists feel would be realized in the way of increasing human welfare, through the adoption of collectivism. In the first place, collectivists are convinced that a system of this kind would eliminate most of the wastes of competition. Since production would be socially controlled, there would be little danger of competitive duplication of productive facilities and human efforts such as mark capitalistic economic systems. Every industry would be organized into pro-

ductive units of the most efficient size, and no more units would be set up than were needed to turn out the socially desirable amount of goods. Advertising, if it existed at all, would be used to strictly educational and instructive ends. With production organized for use and not for profit, there would be little danger that productive agents would be used to make trivial goods so long as important human wants remained unsatisfied, or that industries which produced useless or harmful goods would be tolerated under socialism. Since production would be organized with the interests of society at heart, collectivists believe that human wants as a whole would stand a much better chance of being completely satisfied under socialism than under capitalism.

Individual and Social Interests.—We have already said that in a capitalistic system, the interests of individual enterprisers often lead to the limitation of certain types of goods, while the best interests of society as a whole require these goods in abundance. This conflict of interests, collectivists say, would be eliminated under collectivism. Those who managed and directed the affairs of industry, being merely employees of society and unable to make profits for themselves under any circumstances, would have no incentive to restrict production in any industry. Their interests, like those of society, would be best served by producing in abundance. Moreover, it is said, collectivism would provide a remedy for the present practice of delaying the introduction of new inventions, in the interest of large profits, and consequently the best equipment and methods would be promptly available for all productive units.

It is argued, also, that the ordinary workers in industry would be more efficient under collectivism. Since they would be working for society instead of profit-seeking private enterprisers, they could count on getting their full share of the national income. As a result, labor unrest, strikes, boycotts, and other types of labor troubles should disappear. And since there would be work for all, and no fear of unemployment, there would be no incentive for workers to "soldier on the job" to make their jobs last, or to oppose the introduction of scientific methods, improved machinery, and labor-saving devices. By removing the greater part of the present conflict between individual and social interests, it is held, collectivism would contribute greatly to the efficiency of production.

The Elimination of Business Depressions.—Under either socialism or communism, it is said that business depressions would be unknown. The supply of purchasing power under socialism would be completely controlled by the central government and would never be allowed to operate, as it sometimes does under capitalism, as a force making for business booms and depressions. Production would no longer be planless and chaotic, because decisions as to what should be produced and how much should be produced would no longer be left to thousands of independent and uncoordinated individuals as under capitalism. Final decisions of these kinds would be made by the central authority, and misdirected production would not occur unless the central agency made mistakes in gauging the desires of consumers or were unable to meet these desires. Since production under collectivism would still be roundabout in character and would still be undertaken for a future market, it would be quite possible for misdirected production to occur. However, with the selling prices of products completely under the control of the central authority, it would be possible to induce consumers to take an unusually large output of some good off the market by lowering the price sufficiently or to restrict the consumption of another good, limited in quantity, by raising the price. Since costs and prices would mean little in such a system, misdirected production, when it occurred, would not be a force making for economic depression.

Moreover, under collectivism there would never be an incentive to close down an industry or to reduce its output, unless the desires of consumers for its products were completely or very nearly satisfied. In other words, the time would never come under collectivism, as it does under capitalism, when business uncertainties could cause managers to discharge workers or put them on part time, to reduce purchases of materials and supplies, and to take the other steps which today lead to the vicious downward spiral of depression. Business managers, under collectivism, would be working for society, would not receive profits in any event, and would never reduce production unless instructed to do so. Thus, it is claimed, business depressions would under collectivism be only a bitter memory.

The Employment of Labor.—It is contended that under collectivism there would always be employment for all persons able to work, while generous provision would be made for those unfortunate individuals who were unable to contribute to pro-

duction. In fact, all who were able to work would be required to do so in order to receive any income. Under capitalism, the ability of workers to find employment depends upon whether those persons who control land and capital can make a profit by using the workers. Under collectivism, with land and capital owned by society, workers could always be used with profit to society so long as human wants were not completely satisfied. The cost of putting laborers to work in a given line of production is, from the social point of view, only the necessity of providing them with land and capital which could otherwise be used to produce other goods. In short, the only costs would be opportunity costs, and there would be plenty of employment for labor as a whole. And if society ever managed to produce more than enough goods to satisfy the wants of consumers, it would reduce hours of work for all citizens and allow all to enjoy more leisure time. There would still be employment for all.

Saving and Investment.—Finally, it is contended that the twin processes of saving and investment would be much better coordinated under collectivism than under capitalism. Under the latter system, people often desire more funds for investment in industry than are currently being saved, so that the banks have to create extra purchasing power for investment purposes. At other times, savings pile up in our financial institutions and cannot find profitable investment. These evils, it is claimed, result from leaving these processes in the control of private individuals who react to price considerations. The processes not only are carried on wastefully, but they have important repercussions in connection with business cycles. Under collectivism, saving and capital formation would mean merely that society would choose to direct a part of its productive resources into making capital goods rather than consumers' goods. Society would not be so silly as to deprive the people of consumers' goods at a given time unless there were a real need for further supplies of capital goods; and, on the other hand, society could always withhold from its citizens enough consumers' goods to make possible the creation of any amount of capital goods, however large. Thus, saving and investment would really be a single process under collectivism.

Criticisms of Collectivism

Collectivism and the Family.—It is small wonder, then, that collectivists find in the possibilities of their projected social order

a picture which they think should be attractive to many who suffer from the imperfect workings of capitalism. However, it would not be fair to leave the subject of collectivism without considering some of the objections which are raised against the proposals that we have described. Some of these objections are weighty indeed, while others do not appear to be so well founded. We shall discuss the latter objections first.

There is a widespread idea in this country that socialism or communism would involve the breakdown of the institutions of marriage and the family, and that collectivists believe in "free love," the nationalization of women, or some other radical idea with respect to relations between the sexes. Now, it is undoubtedly true that some collectivists harbor extreme ideas of this kind, but so also do many individuals who are not collectivists. In general, collectivists are inclined to believe that marriage and the family would reach their most perfect development under collectivism, because these institutions would then be freed of economic considerations. With a fair distribution of the national income, an ambitious young man would have no need to marry the boss's daughter, nor would a woman be tempted, for economic reasons, to espouse a rich but otherwise unattractive individual for whom she had no real affection. No one would be forced to abstain from marriage because of economic necessity, and marriage and the family would come to have a sound basis in mutual admiration and affection.

Collectivism and Religion.—In like manner, there is a popular notion that collectivists are atheists and would put an end to religious activities. Now it is true that collectivists are usually bitterly opposed to state churches, whenever these religious institutions work hand in hand with the political organization to keep the people in subjection. Undoubtedly, some collectivists are disgusted with the religious institutions of the present time; and it is likewise true that some people who are collectivists, and others who are not, convinced as they are that social reform can be accomplished here and now, are impatient with any religion which encourages people to be humble and resigned to hardship and privation in this world so that they may be more fortunate in the next. However, there is little or nothing in collectivism to support the belief that, in a new social order, religious activities of all kinds would be ruthlessly suppressed and discouraged.

The Control of Production.—Not all objections to collectivism can be disposed of in this summary fashion, however. There are many people who believe that it would not be possible, as a practical matter, for society to control all economic activity. They believe that no men are sufficiently intelligent and capable to look after the economic affairs of 130,000,000 people more efficiently than these millions can individually direct their own affairs. Regardless of the statistical data that might be assembled and the number and character of the subsidiary organizations and agencies set up, a central planning commission would find the economic activities of this country too great and too complex for effective central control. According to these critics, it would require superhuman wisdom to decide what goods should be produced, to coordinate the activities of different industries, to control the purchasing power of the country, to keep all able persons employed, to devise a fair principle for the distribution of income, and to balance properly the production of consumers' goods and capital goods. They hold that governments have always proved inefficient in operating industries, and that, if all economic activity were to be subjected to political control, the result would be chaos many-fold worse than the disorganization and inefficiency which collectivists complain of under the present system.

The collectivists naturally do not accept these objections as sound. They admit, of course, that the change from capitalism to collectivism would not endow men with superhuman wisdom and infallible judgment. Many mistakes would undoubtedly be made in planning and carrying out the economic activities of a collectivistic society. But they insist that the probable achievements of collectivism should be compared, not with the results which would be realized under a perfectly functioning capitalistic order, but with capitalism as it has been and now is. Since some critics of our capitalistic order contend that its efficiency in satisfying human wants is but little, if any, more than 50 per cent of what might be accomplished in the existing state of the arts of production, collectivists feel that there would be some gain at least under their system. Such mistakes as might be made in planning the nation's economic affairs would tend to be overcome as we gained experience in planning. At any rate, our people would probably be more tolerant of mistakes made in the attempt to serve the best interests of society as a whole than of those which admittedly result under capitalism when individuals

seek their own private interests. Given adequate information and well-developed subsidiary planning agencies in the many lines of economic activity, the collectivists feel that national economic planning is distinctly feasible and well worth trying. However, despite these claims, we believe that the practical possibility of social control over economic activity is still a debatable question. It is one which can be fully answered only by experience, and not in advance of the event.

The Selection of Leaders.—Another important question relates to the selection of leaders—those who are to fill positions on planning commissions and manage the great industrial units. Babies do not come into the world conveniently labeled "leaders" and "non-leaders"; and the men who develop leadership under capitalism do not always show exceptional prowess or promise as youths and young men. Leaders under capitalism are forged in the crucible of experience, and reach their exalted positions, as a rule, fairly late in life. Of the many who try to become great industrialists, only a few succeed. It is thus that we develop our leaders. Under collectivism, the selective influence of competition would be lacking. How, then, could leaders be chosen?

The collectivists would probably answer that, in their system, it would not be a matter of discarding all of our present industrial leaders and developing new ones from the masses at once. If collectivism were peacefully achieved, an effort would probably be made to leave those important executives and managers, who appear to merit their present positions, in places of responsibility. It is felt by collectivists that much managerial ability goes to waste under capitalism because many persons who possess ability cannot get the training necessary to fit them for high positions, or because they lack the capital or connections to make them eligible for these posts. Under collectivism, such training would be given to large numbers of people and it should be possible to select some persons who would eventually qualify for key positions in the economic order.

Incentives Under Collectivism.—Probably the most important question raised in connection with collectivism is whether, under such a system, individuals would have an incentive to work hard and make full use of their talents and abilities. Under capitalism, everyone has the incentive of personal gain to spur him on in developing his abilities to the utmost, and obtaining the highest position for which he can qualify—for large incomes and great

wealth come to those who are conspicuously successful. While collectivism, as we have seen, probably would not mean absolute equality in the distribution of income, it is certain that inequality would be largely eliminated and differences in income would be very small as compared with those of today. Moreover, the larger incomes under collectivism would at most mean merely higher standards of living. No one could pile up property rights in land and capital to insure himself later a permanent income without working, or to found a family fortune. Of course, under capitalism, not all who seek great riches actually attain them, but it is commonly held that the opportunity for economic advancement affords an incentive to all. What would be the incentives under collectivism?

The question would be important and applicable to all grades of workers under collectivism—from the head planning commissioner down to the lowliest worker. Of course, all who had the ability to do so would be required to work for their incomes, but how would efficiency be achieved among the rank and file? The man who just met the minimum requirements of his job would receive almost as much income, and have possibly as much leisure, as the one at the next machine who worked with great zeal. No one would hold any effective power of discharge over the inefficient worker, as the employer does under capitalism, because society would be obligated to furnish employment for all who were able to work. Of course, negative incentives might be provided in the form of penalties for laxity, but it is questionable how effective or desirable they would be.

What incentive would one have under collectivism to aspire to a high position in an industrial unit, with all its worries and responsibilities, if the wage paid were only slightly higher than that paid to workers in the ranks? What incentive would there be for a man in such position to be as efficient as possible, when he could not hope for profits, could not accumulate land or capital, and could not in any event pass on accumulated wealth to his heirs? Opponents of collectivism urge that, in the absence of our customary economic incentives, economic efficiency would decline and the national income would fall until, no matter how fairly it was divided, there would be poverty, and not plenty, for all. They suggest, further, that a collectivistic society would be stagnant and unprogressive, since its members would not invent

new machinery and devise improved methods of production, if they could not profit personally by their use in industry.

As usual, the collectivists have ready answers to these objections. The capitalistic system, they say, does not provide incentives for all. The great inequality of wealth and income discourages the poor and limits their efforts, while the possession of great wealth by others gives these favored persons the best possible incentive to do nothing at all. Even under capitalism, some people work hard to win the esteem and admiration of their fellow men, or because they are interested in the welfare of society as a whole. Under collectivism, in the absence of economic incentives, these other motives would flourish and develop unprecedented vigor. Moreover, some differences in incomes would be granted under collectivism and, it is held, even these differences might provide considerable incentive in the absence of large differences in income with which to compare them unfavorably. Even if it were difficult to furnish adequate incentives under collectivism for individuals who had become accustomed to such "bribes" under capitalism, it is held that after a generation or so the old system would be forgotten and the non-economic incentives of a collectivistic system would be adequate. Finally, if worst came to worst and the national income should decline or fail to grow, the collectivists suggest that people would not greatly mind being in moderate circumstances if there were none who were sufficiently well off to make them feel their poverty. In so far as incentive for inventors is concerned, the collectivists point out that very few inventors reap great rewards under capitalism, since most of the profit that results from their efforts goes to business men who exploit the inventions. Nevertheless, inventors continue to work, apparently largely for the sheer joy of devising new things, or for other non-economic reasons. Moreover, many inventions have been made by university or governmental employees who have not attempted to turn their devices into private gain.

In discussing incentives we are admittedly on uncertain ground. People have long been arguing about the extent to which man requires economic gain if he is to be stirred to productive activity and the extent to which he may be spurred on by other motives. It seems clear that there are very considerable differences among individuals as to their reactions to incentives, and that the matter must be submitted to the test of further experience.

Freedom Under Collectivism.—Finally, there are some people who urge that collectivism should be avoided because it could succeed, if at all, only through regimentation, and the subordination of the individual to society. A person would no longer be free to follow his self-interest in his own way, he could not choose his own line of work and decide how much or how little to produce, nor would he be allowed, as he is allowed today, to pile up wealth and spend or give it away as he might see fit. Under collectivism the interests of society would be superior to the interests of individuals. It were better by far, say the exponents of individualism, to have liberty and possible poverty, than to enjoy a comfortable, assured income at the cost of one's freedom.

But the collectivists answer this argument by saying that most people, under capitalism, have very little freedom to lose. Political freedom they may have, but few indeed enjoy true economic freedom. Freedom of enterprise and self-interest, for most people, are a snare and a delusion. The average man chooses rather the corporation for which he will work, than the line of business into which he will go as enterpriser. The captain of industry says "Come," and thousands of people have work. He says "Go," and the same thousands are idle and must turn to charity or relief for their maintenance. He decides to lower wages and his employees tighten their belts, and grin and bear. If the workers organize in order to bargain collectively, the great industrialist attempts to smash their union, if it is of a type which he will be unable to control. If the government legislates on hours and wages, the courts void the laws and protect the workers' right to work for as low wages as they will, rather than to let their freedom of contract be destroyed. If this be freedom, say the collectivists, it is the freedom to starve rather than to earn a fair living. And hence they conclude that most people are wage slaves under capitalism and can be set free only by collectivism.

Cumulative Dissatisfaction Under Collectivism.—We have now examined the most serious objections to collectivism, but we may mention two further points. There are some who contend a system of collectivism could not long endure, because its members would become increasingly dissatisfied with the commodities and services furnished them by the government. Even now we grumble about many of the goods we buy, but our complaints are directed against many enterprisers. We feel that we are over-

charged for electricity, but forget this grievance when we encounter the high price of gasoline, and we cease condemning the oil trust to complain of the outrageous price of milk. Thus, one grievance tends to cancel another; but under collectivism all dissatisfaction and condemnation would be concentrated upon the central government—the only business enterpriser. This objection is one to which no definite answer can be made one way or another; but it seems probable that if the national income were large and well diffused, the problem would not prove to be a serious one.

The Population Question.—Finally, some critics suggest that population would tend to increase under collectivism, and that this increase might lead to the downfall of the system. The theory is that population is held in check under capitalism by the desire for economic advancement on the part of the people, since too many children may keep a family from "getting ahead." Under collectivism, with jobs at good wages guaranteed to all and support assured for one's children as well as for oneself, families might increase in size to such an extent that standards of living would be sharply reduced despite our best productive efforts. Here, again, we are in the field of speculation. In Chapter 5, we noted that the number of children in a family is influenced to a certain extent, and often to a considerable extent, by non-economic considerations. Public opinion might, under collectivism, prevent an unduly great increase in numbers. Judging from our present society, we may suggest that improvements in incomes would not seem likely to lead to families of large size. In our society today, the largest families are often found among the most wretched and miserable groups. It seems possible, indeed, that the assurance of a satisfactory income to all workers might help to hold the population in check rather than to increase it. On the whole, then, the matter of the size of the population under collectivism is very largely one of conjecture.

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1. Why do collectivists think that the capitalistic type of economic system must be abandoned?
2. List the characteristics of collectivism in general.
3. On what grounds do collectivists condemn the capitalistic system of distribution?
4. What is meant by "the competitive wastes of capitalism"? Explain.

5. Are periodic business depressions inevitable under capitalism? Why or why not?
6. State briefly the nature of the major theories of Karl Marx.
7. Are these theories generally accepted today? Explain.
8. Distinguish briefly between socialism and communism.
9. Why do socialists and communists believe that land and capital should be owned by society?
10. How would land and capital be brought under social control?
11. What is meant by "the collective management of land and capital"?
12. How would the national income be distributed under socialism? Under communism? Explain.
13. Compare saving and capital formation under socialism or communism, with the same processes under capitalism.
14. To what extent would a socialistic economy make use of money and the price system? Why?
15. Why might a collectivist society have less need for a price system than a capitalist society?
16. Why is it claimed that collectivism would eliminate the competitive wastes of our present system?
17. Could collectivism reconcile individual and social interests? Explain.
18. Would business depressions occur under collectivism? Why?
19. Why would collectivists expect to have a full employment of labor under their system?
20. Would a system of collectivism result in the destruction of the family and of religious institutions? Why?
21. Why do many people think that society could not effectively control all economic activity? What is your opinion on this point?
22. How could a collectivistic economy select its leaders? Explain.
23. How are individuals induced to engage in economic activities under capitalism?
24. Could satisfactory incentives to efficiency be provided under collectivism? Explain.
25. Should collectivism be avoided because it would result in a loss of freedom for the individual? Explain.
26. Would the population problem bring about the downfall of a collectivistic economy? Why?

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25 THE SOVIET MOVEMENT

PRESENT-DAY RUSSIA AFFORDS AN INTERESTING AND IMPORTANT EXAMPLE OF A NATION OPERATING AS A PLANNED ECONOMY. SO long as no country actually attempted to operate on a socialistic basis, discussions of the methods and possible achievements of a planned economy remained on a highly theoretical plane. But Russia—or the Union of Soviet Socialist Republics, as it is now officially called—has provided a modern example of collectivism. With a land area of 8,195,000 square miles and a population of some 165,000,000, Russia has undertaken to substitute a socialistic economy for the capitalistic economy of her past.[1] The Soviet movement is deserving of careful study.

Early Developments.—Russia did not become a planned socialistic economy overnight. Soon after the capitalistic order was overturned by the revolution of 1917, an attempt was made to establish an economic system that would use none of the known means of economic control. Money and prices were to be discarded. Consumers' desires were to be provided for through a system of rationing, and producers' needs by deliveries against special warrants. Nationalized factories were to furnish supplies of the various kinds of economic goods, while the Supreme Economic Council estimated the kinds and quantities to be produced. Industrial conscription was to be employed, to a considerable extent, to insure that workers performed the proper tasks. Russia had never achieved great success as an industrial nation prior to the World War, but, under this unprecedented and untried type of economic system, economic activity fell off to a small fraction of even its pre-war level.

In 1921, a new economic policy was adopted which restored money, prices, and buying and selling activities, and economic planning was attempted on a modest scale. Production revived gradually under this new policy, and by 1927 it had about

[1] *Handbook of the Soviet Union,* New York, The American-Russian Chamber of Commerce, 1936, p. 1.

reached its pre-war level. At this time, the first Five-Year Plan was drawn up, providing for a comprehensive program of economic planning. This Plan was announced as completed in 1932, after a little more than four years of operation, and the U.S.S.R. (as the Soviet Republics are commonly called) has now completed its second Five-Year Plan. The government of the U.S.S.R. was established by treaty in 1923, and operated until a new constitution was adopted in 1936. To describe economic activity as it is carried on in the U.S.S.R., it will be necessary for us to examine briefly the government of Soviet Russia, both old and new.

The Government of the U.S.S.R.

The Communist Party.—Any account of the government of the U.S.S.R., which failed to describe the nature and importance of the Communist Party, would be incomplete indeed, for the government and the party have been one and indivisible. The Communist Party, in other words, has had outright control of political and economic life in the U.S.S.R. While the party numbers only about 3,500,000 persons, or two per cent of the population, and while many non-Communists are allowed to vote and, at least in theory, may be elected to office, most of the important economic and political positions in the country have, in fact, been held by party members, and the party has formulated all of the important policies which have been carried out by the government. It is the only political party permitted to exist in Russia today.

About half of the party members are industrial workers, the rest being peasants and intellectuals. New party members are drawn largely from the Young Communists, an organization with about 5,000,000 members, all under 23 years of age. This organization, in turn, has a subsidiary known as the Young Pioneers, which includes about 6,000,000 children between the ages of 10 and 16.[2] The party is highly organized, the organization progressing from factory, village, and city units, through district and regional congresses, to the All-Union Communist Party Congress. Membership in the party is something of an achievement. A person is placed on probation for a period before being taken into membership, and the party has periodic "purges" which are intended to rid it of members who fail to live up to party

[2] *Ibid.*, p. 15.

standards. The party insists upon conformity to standards of personal conduct, as well as enthusiastic participation in party and civic activities, and enforces rigorous discipline within its ranks.

The Old Governmental Organization.—The U.S.S.R., as established in 1923, was a federation of seven republics. While the government was a federation in form, authority was strongly concentrated in the central government, which controlled all external affairs of the country, and all internal matters of national concern. The lowest units of government were the village, town and factory soviets, or councils of representatives elected by the voters. These soviets were charged with the administration of local affairs. They elected representatives to the district and regional congresses, and from the regional congresses representatives were elected to the All-Union Congress. This latter body was the supreme governmental organization of the country. However, since it had about 1500 members, it was too unwieldy to maintain active control over the country's affairs and met only once in two years. When not in session, its authority was vested in a smaller organization known as the All-Union Central Executive Committee, which met several times a year. When this committee was not in session, it delegated control to a still smaller body, called the Presidium, which had charge of selecting the Council of People's Commissars, a group corresponding roughly to the Cabinet of our own national government. The State Planning Commission, which formulated the economic plans for the country as a whole, was one of the three permanent committees of the Council of People's Commissars. Each of the several republics in the Union had a governmental organization similar to that of the U.S.S.R. as a whole.

Peculiarities of the System.—The governmental system of the U.S.S.R. differed in many respects from our American system. In the first place, elections were indirect in character. The voters of the country elected only members of the local soviets, while representatives in the district soviets were elected by members of the local soviets, representatives in the regional soviets by members of the district soviets, and representatives in the All-Union Congress by members of the regional soviets. Elections were open—that is by show of hands—and not by secret ballot as in this country. The right to vote was granted to all citizens, 18 years of age and over, who performed produc-

tive, socially useful labor; to members of the army and navy; and to citizens who would normally be classed as workers but who were incapacitated. This, however, did not mean anything like universal franchise, because of the soviet definition of productive, socially useful labor. Those who were disfranchised included members of the royalty, police, and secret service under the old Tsarist régime; members of the clergy; persons living on unearned income or exploiting the labor of others; private traders and business men; and the insane. Representation in the soviets was kept, as far as possible, on an economic instead of a geographical basis. That is, the unit of representation was the factory or collective farm, rather than the precinct, ward, and city.

Representation was not accorded to all classes of voters on equal terms. Industrial workers were entitled to one representative for every 25,000 voters, while peasants were allowed only one representative for every 125,000 voters. As a result, the majority of the members of the All-Union Congress were usually representatives of industrial workers. Moreover, as was previously suggested, some three-fourths of the members of the All-Union Congress in 1931 were also members of the Communist Party.[3] Another striking feature was the lack of separation of governmental powers. Legislative, executive, and judicial functions were all performed by the same governmental organizations, whereas in this country these several powers are allocated to separate departments of government, and these departments are watched carefully to see that they do not invade one another's territory.

Finally, under the Russian system, the rights of the individual were very limited. Freedom of speech did not exist. Anyone who criticized the existing state of affairs was likely to be severely punished as a counter-revolutionary. Freedom of the press was unknown. The government had complete control over the printed word, and over all means of communication as well. Freedom of assembly was denied, except to members of the Communist Party. Justice was dealt out on a class basis. Those who became involved in court actions were required to state their social origin; and it is evident that this information might be an important factor in influencing the verdict. Crimes of violence, such as murder, which appear to many nations to be the worst of offenses, were

[3] V. M. Dean, *Soviet Russia, 1917-1933*, p. 9; published jointly by the Foreign Policy Association, Inc., and the World Peace Foundation, 1933.

punished by short prison terms, while counter-revolutionary activities often drew the death sentence.

The New Constitution.—A new constitution for the U.S.S.R. has been ratified and put into operation. On the surface, it appears to make sweeping changes in the Russian system of government. In the first place, the All-Union Congress has been abandoned. The legislative powers of the central government are to be exercised by the Supreme Council, composed of two houses, the Council of the Union and the Council of Nationalities, each having about 600 members. The Council of the Union is elected by the citizens, on the basis of one deputy, or representative, for every 300,000 citizens; while the Council of Nationalities includes twenty-five deputies from each Union Republic, eleven from each Autonomous Republic, five from each Autonomous Province, and one from each National Region. All terms of office are four years in length, and the two legislative houses have equal rights. Laws are passed by a simple majority in each house, and each house elects a Chairman and two Vice-chairmen. The legislature is to meet twice a year.

The Supreme Council is to select the Presidium, which is really a committee of the Supreme Council. The Presidium has certain powers, such as the power to disband the Supreme Council in the event of permanent disagreement between the houses, to call new elections, to call meetings of the Supreme Council, and to exercise many of the legislative functions of the Supreme Council when that body is not in session. The highest executive or administrative organization of the U.S.S.R. is the Council of People's Commissars, which is selected by the Supreme Council and is responsible to it. The State Planning Commission is presumably, as before, a committee of the Council of People's Commissars. Justice is administered by the Supreme Court of the U.S.S.R., the Supreme Courts of the Republics and Autonomous Regions, and the People's Courts. The several Supreme Courts are selected by the Supreme Councils of the U.S.S.R. and its constituent republics and regions, but the People's Courts are elected by direct vote of the citizens in the various districts. Every Union Republic and Autonomous Republic has a governmental set-up almost identical with that of the U.S.S.R. The soviets—or village, city, district, and regional governmental organizations—are retained, but their members are elected directly by the voters.

The government of the U.S.S.R. is still federal in form, but, as before, power is concentrated largely in the central government. The central government controls all external affairs of the country, including a monopoly of foreign trade, and internally controls the planning of the national economy, approves the budgets of all governmental units, administers banks and all productive or business establishments which are of All-Union importance, administers transportation and communication, controls money and credit and the use of land, provides a single national system of accounting, controls education and public health, and establishes principles of labor legislation and of legislation governing the judicial system and procedure.

Effects of the New Constitution.—It is clear that, under the new system, the legislative, executive, and judicial powers of government are exercised by separate organizations, although the legislature remains superior to the other two departments of government. Direct elections are almost universally substituted for the old indirect elections. Even members of the Supreme Council are elected directly, whereas the old All-Union Congress was several stages removed from the actual voters. Suffrage is universal for persons 18 years of age and over, with the exception of the insane and persons deprived of electoral rights by court sentence. All classes of voters have equal rights of representation in the legislative bodies, and elections are by secret ballot. However, there is still economic rather than geographical representation, for this principle is fundamental to the Russian system.

Under the new constitution, equal rights are guaranteed to all citizens. All are granted freedom of speech, freedom of press, freedom of assembly and of holding mass meetings, freedom of street processions and demonstrations, and freedom of religious worship. Citizens are guaranteed inviolability with respect to their persons, homes, and correspondence. Going beyond the constitutional provisions of other countries, the new Russian document guarantees the citizens employment and payment for their work in accordance with its quantity and quality, the right to rest and leisure, the right to maintenance in old age, sickness, and accidents, and the right to education. Women have equal rights with men in all spheres of life.

This appears to be a most enlightened constitution and governmental system, in comparison with what has gone before. It would seem to be possible now for a non-Communist to be elected

to any office in the land; and the government will apparently be much more sensitive to the will of the people than before. However, it may be questioned just how much these changes in governmental organization will mean, so long as the Communist Party is the only political party in the country, and how important personal rights will be so long as the Communist Party controls governmental activities. Thus far, the houses of the legislature appear to be mere figureheads, approving whatever measures the party leaders present to them, and the recent bloody purges suggest that individual citizens still have few, if any, civil rights in Russia.

The Planning and Control of Industry

In considering the operation of Russia's economic system, we must always bear in mind the fact that Russia is operating under a socialistic system. That is to say, land and capital are socialized and are owned by society, the former entirely and the latter largely. Therefore, it falls to the lot of society, working through the established agencies of government, to plan and direct the use of these basic means of production. In noting how these plans are made and carried out, we shall consider agriculture separately, for the arrangements in agriculture are quite different from those in manufacture.

The Planning of Industrial Production.—Though there are some differences as between industries in the field of manufacture, the general outlines of industrial organization are quite clear. The individual enterprises or factories, operated by governmental units or cooperative organizations, are gathered together into trusts or combinations, sometimes one trust to an industry and sometimes more. The trusts exercise a considerable measure of control over the factories, and for some purposes the trust, rather than the factory, is the industrial unit. For example, the trust controls raw material supplies for its factories and markets their output. The prices at which this output is sold to other governmental agencies are determined for the trust as a whole, rather than for individual factories. There is also a central agency for each industry, called the Central Administration, which supervises the work of the subsidiary organizations in the industry, and sees to it that the industry carries out its part in the general economic plan. Finally, the Central Administrations for various industries come under the control of a People's

Commissariat. Thus, the Commissariat for Heavy Industry recently had under its control the Central Administrations for some thirty branches of industry, such as the administrations for the tractor and automobile industry, the machine-building industry, and the power, coal, and oil industries. The Commissariat for Heavy Industry is one of the departments under the Council of People's Commissars, which we mentioned previously as the principal administrative agency of the government.

The general objectives to be undertaken by the economic system are drawn up by the Congress of the Communist Party for several years at a time. However, within the general outline of such objectives, it is necessary to draw up detailed plans for each industry and the system as a whole, for a period of five years and in each given year. The State Planning Commission, a subsidiary of the Council of People's Commissars, draws up such plans tentatively. Then each Administration, trust, and factory or industrial unit is called upon to plan its own output and other affairs for that period, giving details as to the output it expects to turn out, the number and type of men it needs, the amount of working capital it would like to have, and so on. These plans go upward from the factories through the trusts and Central Administrations to the State Planning Commission, which revises and criticizes the plans, compares them with the preliminary plans which were drawn up, and drafts the final plan for the period for the economy as a whole. Then, the several sections of the plan which affect the subsidiary organizations in each industry are sent down the line again, so that each organization or unit may know exactly what is expected of it for that period.

The Control of Production.—It follows, therefore, that the activities of every industrial unit are quite closely circumscribed. A plant is given a specified output to achieve, or to exceed if possible, it is told the amount and kinds of labor it may have and the wages to pay, the amount of working capital which it is granted or may borrow and what is to be done with this capital, the amounts of materials and supplies it may have and at what prices, and the agency to which it is to sell its output and at what price. It is clear that the plans are both physical and financial in character. From the physical point of view, they are a matter of so many units of product, so many workers of various kinds, and so much land and capital. From the financial point of view,

both selling prices and costs of production are predetermined for the several industrial units.

It was something of a problem to set prices at which goods were to be sold to the governmental agencies which would then proceed to distribute them to consumers. If the government had set any one price for all concerns making certain products, some concerns could have made profits without striving greatly for efficiency, while others would have been unable to cover costs no matter how hard they tried. On the other hand, to specify different prices for identical goods produced in different factories, would lead to many complications. The problem was solved by having every trust take over the output of its individual factories and sell them at one price established by a price-fixing commission. This price is supposed to be sufficient to cover the planned costs of the subsidiary factories as a whole and the costs of running the trust, and to provide also for the payment of the "turnover" tax from which the government derives a large part of its revenue. The trust then computes what part of the price must be turned over to the individual factories to cover the money costs which they must meet, and the remainder is retained by the trust itself.

The Relation of Prices and Costs.—We see, therefore, that money is used in the U.S.S.R., and prices and costs are expressed in terms of money, but the relationship between prices and costs in a capitalistic order like the United States of America is very different from their relationship in Russia. The prices that Russian productive establishments are allowed to charge are supposed to cover costs and yield a profit, given normal efficiency on the part of the productive units; but these prices are not necessarily the same as those charged to consumers. In some cases, the prices charged consumers are less than those received by the industries, so that the government is, in effect, subsidizing these particular industries. In other cases the reverse is true, and the government reaps a profit on its sale of certain goods to consumers. Of course, when profits are made under the Russian system, they do not go to private individuals as in this country.

Another important point is that the relationship between costs and prices does not control production in the U.S.S.R. In our system, if the price at which a good can be sold to consumers is for a long time too low to cover costs of production, the quantity produced will be restricted; and the receipt of prices which are

more than enough to cover costs of production will have the opposite effect. In Russia, however, production is controlled by the government and it may be decided to increase production in a non-profitable industry or to decrease it in a profitable industry, if such measures appear to be desirable from the point of view of public welfare. Prices and costs are used merely as accounting devices in Russia. They furnish a convenient medium for expressing the content of plans for different industries, and for comparing the results achieved. Since each productive establishment has its costs and prices determined for it, it makes or does not make profits according to the efficiency with which it operates. A lack of profit in a particular year may mean little or nothing with regard to efficiency, but long-continued losses by a productive establishment are at least *prima facie* evidence of faulty operation. Such losses might lead to a reorganization of an establishment or to a change in management, but the fact of a profit or loss plays little part in influencing decisions of the government as to what goods shall be made or the quantities in which they shall be made.

The Problem of Planned Production.—In our own system, consumers express the relative strength of their desires for different economic goods through their willingness to pay high or low money prices, and producers presumably are guided by these prices into producing the goods most desired by consumers. But in Russia the government, through the State Planning Commission, decides what shall be produced and in what quantities; and the important question is how well production can be adjusted to meet the desires of the people as consumers under this system. In part, this coordination depends upon the temper of the planning authorities. If they decided to devote the productive resources of the country to building up a huge war machine or to supplying the country with large amounts of capital goods immediately, consumers' wants may go largely unsatisfied for a time. However, if the authorities undertake to adapt production to consumers' desires, a very considerable degree of success may be achieved. Up to the present time, it has been relatively easy to dispose of the things which were produced, because the Russian people were so desperately in need of all kinds of goods when planned production was started. Later on, when basic wants are more nearly satisfied, the problem of adjusting production to human desires may become a more serious one. However, it

should be emphasized that, if maladjusted production should come about, it would not lead to a breakdown of the system. For the government controls prices and can always get rid of goods by lowering prices sufficiently or discourage their purchase by raising prices; and eventually, of course, it may be possible to adjust production so that it will be closely related to consumers' desires.

The planning authorities can measure the success of their production policies in satisfying human desires by observing the alacrity or reluctance with which consumers take economic goods off the market. In the past, however, such information was not completely reliable, for the Russian government rationed certain commodities among the consumers at artificially low prices. Under these conditions, neither the demand for rationed commodities nor that for non-rationed commodities gave an accurate picture of consumers' desires. Since people were allowed to buy only certain quantities of the rationed commodities, it was impossible to decide how much more of their incomes they would have spent on these goods had they been permitted to do so. On the other hand, their purchases of non-rationed goods may have been much greater, *because some commodities were rationed,* than they would have been if the people had been free to spend their incomes as they desired. Now that the rationing of many kinds of consumers' goods in the U.S.S.R. has been discontinued, the reactions of consumers to planned production at planned prices will be a safer guide to the planning authorities than in the past, if they care to make use of them.

Some hope for success in the adjustment of planned production to human desires arises from the fact that the planning authorities in Russia are able to avoid some of the pitfalls of capitalistic systems. Without any great effort, the authorities decide that luxurious yachts and limousines shall not be built so long as the people have unsatisfied wants for food and clothing. It is similarly easy to decide that worthless patent medicines and other harmful goods shall not be made while the people lack adequate housing It is possible to standardize the products turned out, instead of permitting the production of many competing varieties, and, of course, productive resources are not wasted in creating competitive advertising designed to lure customers from one brand of a product to another or even from one product to another. Finally, having decided the volume of output to be

achieved in each industry, the planning authorities can see to it that the productive facilities of the industry are only sufficient to insure this output. The output decided upon may or may not be the proper quantity from the point of view of consumers, but in any case it is possible to provide for the amount planned without the wasteful duplication of productive facilities, which is characteristic of competitive economic systems.

Agriculture in the U.S.S.R.

Agriculture in the U.S.S.R. is planned in much the same way as manufacturing, but the government does not have the ability, in the case of agriculture, to supervise directly the operation of the plans. The government owns farm land as it owns other kinds of land, but it actually directs only a relatively small part of agricultural production. For the most part, reliance is still placed on individual initiative and the incentive of pecuniary rewards to induce the farmers to produce in abundance.

The State Farms.—Agriculture in the U.S.S.R. is organized in three main forms. First, there are state farms. These are controlled by the government through agricultural trusts and their organization is sufficiently similar to that of other industries to make a detailed description unnecessary. The total output of these farms must be turned over to the appropriate governmental agency at specified prices, and the workers on these farms are paid wages. During the first Five-Year Plan (1928-32) the number of state farms increased from 3125 to 10,200, and their cultivated area increased from 1,735,000 hectares to 13,557,000 hectares, or from 1.5 per cent of the total cultivated area of the country to 10 per cent.[4] The number of state farms is still expanding in the face of many problems, such as determining the best methods and policies to be used in conducting large-scale farming, the training of efficient managers, and the training of workers who have had no previous experience with modern farm machinery; and it is probable that a gradual shift of agricultural activity from other types of farms to the state farms is desired by the government.

The Collective Farms.—Collective farms are the most important type of farm organization in the U.S.S.R. at the present time. Most collective farms are organized as "artels." Under this form of organization the peasant retains his dwelling, livestock for purely domestic use, household goods, and possibly a little land

[4] *Handbook of the Soviet Union*, pp. 219, 220.

for a garden, but the rest of the land and the buildings, machines and tools, and livestock are used collectively. The peasants work in common, performing planned and assigned tasks under group leaders. They receive wages as they work, which are really advances against the harvest, and their wages differ according to individual efficiency and skill.

The government is anxious, of course, that the collective farmers shall grow more farm produce than they themselves need, so that the needs of the urban population also may be satisfied. However, since the government does not control the operation of these farms, an incentive is needed to induce these farmers to produce in abundance. Several schemes have been tried with but indifferent success. At the present time, the collective farms are required to turn over a certain fixed proportion of their produce to the appropriate governmental agency at fixed prices. These prices are not very high, and the government quotas may almost be regarded as a tax on the farmers. All farm produce above the quotas belongs to the collective farms. They use part of this excess for consumption and for reserves; but produce which is not needed on the farms may be sold either to a governmental agency or on the open market. Hence, these collective farmers depend upon money prices almost as fully as do farmers under capitalism, and are likely to vary production according to the prices obtainable for their marketable products and the amount of manufactured goods they can get from the sale of their surpluses. Under the first Five-Year Plan, the number of collective farms increased from 33,000 in 1928 to 217,000 in 1932, and their cultivated area from 1,370,000 hectares to 91,579,000 hectares, or from 1.2 per cent of the total cultivated area of the country to 68.1 per cent.[5] Since 1932, the number of collective farms has been increasing, and they now control almost 90 per cent of the cultivated area.

Peasant Farms.—Finally, some farms are still operated by peasants individually. They do not, of course, own the land, but they support themselves by working it and selling their surplus products. They must, like the collective farmers, sell a certain percentage of their output to the government at fixed prices and, in general, they are treated somewhat more harshly in this respect than the collective farmers, in order to discourage the individual type of farming. They may sell their surplus products in the open market at any prices obtainable. This type of farm has

[5] *Ibid.*, p. 223.

been steadily decreasing in importance in recent years, and may soon disappear altogether.

The Distribution of Income

Land and Capital.—Since land in the U.S.S.R. is owned by society, no private individual receives rent. The available supply of land is apportioned among the various industries in accordance with the plan for economic activity, and no charge, even for purposes of accounting, is made the industries for the use of land. In very similar fashion, the funds which are available for capital investment are apportioned among the industries by the government bank. Here, too, there is no consideration of the possible earnings of capital in different uses or of the rates of interest which various industries might be willing to pay. The assignment of capital funds (and the interest, if any, that is charged) depends wholly upon the plans which have been made in the light of the need for expanding productive facilities in the several industries.

With respect to the volume of new savings, as distinguished from the rationing of existing funds, the situation is a little more complex. Some effort is made to induce people to save. The government issues bonds, at rather high rates of interest, to which individuals may subscribe out of their money incomes. It is difficult to say how successful these loans are, but it is probable that Russia would suffer from lack of capital if private individuals were depended upon to furnish all funds for investment, in view of the needs of the people for consumers' goods, a possible lack of confidence in the security of such investment, and the fact that it may not be well for an individual to seem too prosperous under the Soviet régime.

But probably most of the saving is done collectively. The prices paid business enterprises for their products include an element of planned profits, which are recaptured by the government for purposes of capital investment. Clearly, the amount of these social savings will depend upon the wishes of the government. We must not be misled by methods, however. The cost of saving and capital formation is the same in Russia as elsewhere. That is, the cost of augmenting the supply of producers' goods, or capital, which will make for a more abundant life in the future, is the necessity of accepting for the present a smaller real income in the form of consumers' goods; for, in directing resources into the construc-

tion of capital goods, the productive factors available for turning out consumers' goods are diminished for the time being. There is a wide difference between Russia and other countries in this respect, for, whereas in capitalistic countries the relative amount of saving and present consumption is determined by individuals, influenced by the interest rate and the prices of consumers' goods, the decision on this point in the U.S.S.R. has been made by the government without consulting the consumers. If the government has gone in so extensively for capital construction that immediate income in the form of consumers' goods is unduly diminished, the people have had to adjust themselves to the situation. Under the new political system, with the government more responsive to the will of the people, the wishes of consumers for more goods currently instead of later may receive greater consideration.

The Apportionment of Labor.—Since rent and profits do not accrue to individuals in Russia, and since the amount of interest received by private individuals is negligible, it follows that the national real income available for consumption is distributed in the form of wages. The apportionment of labor among industries and occupations, and the determination of the wages to be paid for different types of labor, have given some trouble to those in authority. Since land and capital are not human agents of production, and have no feelings or home ties, they may safely be assigned in arbitrary fashion to various industries and parts of the country in accordance with the plan. But the case of labor is different. It would be inhumane, and probably uneconomical as well, to assign labor in a purely arbitrary fashion. On the other hand, the workers cannot be depended upon to move spontaneously to the positions in which they are most needed and can be of greatest service to society.

In this dilemma, the government has had recourse, for the most part, to the capitalistic method of rationing the labor supply. High wages or superior rations at government stores have been used to attract workers to industries and posts where more labor is needed, and low wages or inferior rations to get them away from occupations where less labor is required. Because of preferences, habits, and prejudices on the part of the workers, these inducements do not work perfectly in apportioning the labor supply in Russia; but neither do they work perfectly in capitalistic countries. In general, the freedom of movement of Russian work-

ers is so extensive that it has resulted in high labor turnover and much absenteeism.

Differential Wages.—The best of economic plans is of little use unless it is efficiently carried out. To encourage efficiency, it has been found necessary even in Russia to reward exceptionally good work with relatively high wages. It has also been necessary to pay high wages to get people to accept difficult and responsible positions requiring considerable ability and training—particularly in view of the fact that inefficiency and malfeasance in high positions are likely to be punished severely. But the distribution of national income according to the productivity of labor is quite a different thing from equal distribution or distribution on the basis of needs. Moreover, these wage differentials based upon productiveness are especially embarrassing to the Communists of Russia, who have held that common labor is the most honorable of all employments and worthy to be at the top of the economic heap, instead of in its customary position at the bottom. However, embarrassing or not, it has been necessary to make this concession to capitalistic methods.

But it must be said that wage differences in Russia are small as compared with differences in income which exist in capitalistic societies. The ratio between the highest and lowest money wages in Russia was said to be about 12 to 1 in 1937,[6] whereas in this country the ratio between the highest and lowest incomes is thousands to one. Moreover, the differences in money wages in Russia have not meant corresponding differences in real wages. A man with a money income ten times as great as that of another may have had a real income only twice as great, under the old system of distributing consumers' goods. For both men were probably allowed to purchase the same quantities of rationed goods *at low prices*, but the one with the larger money income may have had to spend the balance of it in the open market at prices many times as high as the prices of rationed commodities. Hence, his advantage in terms of real income may have been relatively small. Indeed, workers receiving low money wages were sometimes definitely favored in the matter of rations An attempt has been made also to provide education and training for all who are able to profit by it, so that every person may become qualified for the highest position which his native ability permits.

In fact, the differences in real wages in Russia are so small

[6] *The Nation,* November 13, 1937, pp. 523-526.

that many people question that they will result in efficiency, or even the voluntary acceptance of the more difficult and responsible positions. This problem of providing incentives under the relatively equal income distribution of a planned economy was discussed in the preceding chapter, and need not be enlarged upon here. At any rate, Russia does not depend entirely upon financial or economic incentives in her control of the labor supply. If worst comes to worst, the government has the power to draft or conscript labor to serve in any and all industries, and severe punishments may be imposed for inefficiency. The members of the Communist Party and the Russian Army are also available as an emergency labor force which may be arbitrarily assigned to any type of work anywhere, and the Young Communists are subject to virtually the same regulation. When workers have been placed to the satisfaction of the authorities, there have been devices available to keep them there. These devices have included keeping the workers in arrears in their pay, and issuing ration cards through the factory so that a worker has had to surrender his ration card if he has given up his job.

The Marketing of Consumers' Goods

Rationed Commodities.—Until quite recent times, the process of getting economic goods into the hands of final consumers was very complicated in Russia. While the government furnished some services—and even some commodities at times—directly to the consumers, most goods were distributed among the consumers by means of prices, but prices different from those with which capitalistic countries are familiar. Some commodities were rationed among the consumers by means of ration cards, the possession of which entitled people to purchase specified quantities of these goods at state, factory, or cooperative stores. The use of the ration cards was not merely a method of distributing commodities. It was also a device for conferring favors upon certain classes of people, such as socially important workmen, and for penalizing other classes, such as the nobility, clergy, and secret police of the old régime.

The use of ration cards did not necessarily indicate extreme scarcity of the rationed goods. It merely indicated that these goods were being sold at the stores at prices which were very low in view of their limited quantities. The goods could have been distributed just as effectively without rationing by allowing their prices to

rise to any level to which the competitive bids of buyers might force them. But these high prices would have limited the buyers to a group who could have satisfied themselves from the existing quantities of goods by excluding persons with inadequate incomes. By rationing at low prices, it was insured that most persons, regardless of incomes, would have access to a certain amount of these commodities. The rationing method, however, constituted a severe restriction on consumers' freedom of choice, for ration cards were honored only in terms of the rationed commodities, while the possession of money income, without rationing, would permit the individual to buy whatever he might choose. However, this restriction of choice was probably not a serious matter, so long as rationing was confined to the necessities of life.

Controlled-price Stores and Open Markets.—In other stores, restrictions on buying and selling were not imposed. Here any person might buy any available commodity in any quantity, subject only to his ability to pay the prices charged. Such prices might be high for commodities which were sold also in the open market, or low for those sold also in the ration stores. In the case of the latter, these stores were often recognizable by long lines of people waiting to purchase extra quantities of rationed articles, the supplies of which in these stores were often very limited. Finally, there was a certain amount of buying and selling in the open market. It will be recalled that farmers were allowed to market surplus products in this way, as an incentive to produce in abundance. In addition, articles of such slight importance that their production was not planned, as well as limited quantities of other goods, would find their way into the open market.

Beginning in October, 1935, food rationing was discontinued. Any amount of buying may now be done in all shops. Prices are fixed, but are in general much below the old open-shop levels. This action was made possible by successful harvests, increased industrial production, and improved transportation. It was also planned, in 1935, to open some 5000 new village cooperative department stores by the end of 1936, thus more than doubling the number of existing outlets for goods. With the government almost the sole business enterpriser in the country, it can hardly be said that the prices of consumers' goods are competitive and uncontrolled, but the change noted above is decidedly one for the better. Indeed, the governmental ownership and operation of the basic means of production in the interests of society, combined

with freedom of choice on the part of the citizens as to what they will consume, comes close to the ideal of a socialistic society. The reactions of consumers in the market will now give the planning authorities a more nearly accurate idea than in the past, of their success in adapting planned production to the wants of consumers; and these authorities, in deciding upon the goods to be made, may be more responsive than formerly to the wishes of consumers. This does not mean, however, that the consumers will actually dictate what shall be produced. The government will still be free to produce a given commodity in large quantities, if it is felt that the article should be widely consumed, even though it must be sold at a price well below costs of production. In similar fashion, the willingness of consumers to take other articles at high and profitable prices may be ignored by the authorities, and the output of these articles be limited closely.

International Trade and Money

The Trade Monopoly.—While Russia, as is natural for a planned economy, has tried to make herself economically as nearly self-sufficient as possible, she has had at times to depend upon foreign countries for supplies of several kinds. Moreover, she has tried to make sure that importing and exporting will be carried on only when the country's interests require them, for the international trade of the country is carried on as a governmental monopoly. The government has also monopolized international financial operations, conducting them in the past in terms of an artificial monetary unit which was not used domestically. When a quantity of a foreign product is essential to the operation of the plan, the trading monopoly is in a strong position, for it can sell Russian products abroad at almost any prices in order to obtain purchasing power in other countries. It could, for example, sell wheat abroad at a price only half as high as that which the government paid the farmers, and the government would make up the loss incurred in this way by selling other articles in the domestic market at a profit.

However, the trading monopoly has to be careful about dumping goods abroad, lest other countries refuse on this account to trade with Russia; and, of course, it cannot command higher prices in the world market than the exporters of other countries are getting. Any sharp fall in the world price of a good which Russia is exporting means that a larger quantity than usual of

the good must be sent from Russia to get a given amount of purchasing power abroad. This means, in turn, taking more goods than usual away from the Russian consumers. It is quite clear, then, that in Russia the costs of importation lie in the amounts of exports which must be given up in exchange and hence subtracted from domestic consumption.

Control of the Money Supply.—The issuance of money in Russia, while theoretically limited by requirements for the maintenance of gold or other reserves, is in reality entirely under the control of the government. Moreover, since the government has maintained a monopoly in international trading and in international financial operations, using an artificial monetary unit, the management of the domestic monetary supply has been freed from the influence of such things as international gold movements, interest rates at home and abroad, the international balance of payments, and fluctuations in foreign exchange rates, which are of importance to capitalistic countries under normal conditions. Nothing that happens in the international field can force Russia into inflation or deflation at home, or cause her to expand or contract her currency and credit.

It appears, then, that the monetary problem is simply one of adjusting the supply of money to domestic needs. That is, the government must be sure that the citizens receive enough purchasing power to enable them to remove from the market the available quantities of goods at the prices for which these goods are offered. Under the old system of rationing consumers' goods, it mattered little if too much currency was issued. Since the government controlled prices rigidly, the issuance of excessive amounts of currency could not raise prices but instead could only increase the unspent surpluses in the pockets of consumers. Under the new system of distributing consumers' goods, a similar error might prove more embarrassing.

The use of money involves the use of money prices, and, as we have seen, the Russian planned economy is quite experienced in pricing goods in terms of money. However, it will be recalled that price movements are not so influential in Russia as elsewhere. In distributing consumers' goods among the citizens and in apportioning the supply of labor among industries and occupations, price movements operate to some extent in Russia as in other countries. But they have little, if any, influence on the distribution

of land and capital among industries, on the total volume of saving and investment, and on the determination of the kinds and quantities of economic goods to be produced.

Results of Russian Economic Planning

The First Five-Year Plan.—It is much too soon to attempt a complete or final appraisal of the success of the Russian planned economy, but certain tentative observations may be made. In the first place, the results accomplished under the first Five-Year Plan were little short of amazing, provided the statistics available are at all trustworthy. When the plan went into effect in 1928, economic activity in the U.S.S.R. had reached approximately the pre-war level, but by 1932 the output of 1928 had been left far behind. Some of the results of the planned economic activity of 1928-32 are shown in Table 27. In interpreting this table, it should be remembered that the results shown were obtained in a little over *four* years, while the plan covered a period of five years. In some branches of activity, plan schedules were not fulfilled, but in many branches they were exceeded. Also, some of the results shown were not scheduled in the original plan.

It will be noted that, over the four and one-quarter year period, the national income of Russia almost doubled, and in 1932 was more than double the 1913 figure. Investment in socialized industries increased by more than 2½ times, and in 1932 was well in excess of the plan schedule. The number of industrial workers doubled and average annual wages increased by 70 per cent, both results being well in excess of the plan schedules. Industrial production more than doubled, and in 1932 was more than three times the 1913 output, although it fell somewhat short of the plan estimate. Progress in the output of producers' goods—that is, capital goods—was more marked than in the case of consumers' goods. This result was, of course, the deliberate intent of the plan, but the output of producers' goods exceeded the plan estimate, while that of consumers' goods fell short. The gains in agricultural output were rather disappointing, but indicated a period of transition and readjustment in that line of activity. The mechanization of agriculture went forward with extreme rapidity, and reorganization into state and collective farms proceeded at a pace several times that anticipated by the plan. The figures in terms of roubles in this table were corrected for price

TABLE 27.—RUSSIAN ECONOMIC GROWTH UNDER THE FIRST FIVE-YEAR PLAN, 1928–1932[a]

Department of Activity	1928	1932	Ratio of 1932 to 1928 (%)	Ratio of 1932 to Five-Year Plan Estimate for 1932–33 (%)	Ratio of 1932 to 1913
1. Finance:					
A. National income (billions of roubles)	27.3	45.5	186.1	91.6	202.4
B. Capital investments in socialized industries (billions of roubles)	5 4	19.3	357.4	154.4	—
C. State revenue (billions of roubles)	5.21	30.5	585.0	257.6	—
2. Industry:					
A. Number of workers (millions)	3.1	6 4	201 9	157.1	220.8
B. Average annual wages per worker (roubles)	870.0	1478.4	169 7	120.1	—
C. Output (billions of roubles)	15.7	35.3	224.8	96.4	344.4
D. Output of producers' goods (billions of roubles)	7.0	19.1	272.9	109.8	445.2
E. Output of consumers' goods (billions of roubles)	8.7	16.2	186.2	84.4	271.8
3. Agriculture:					
A. Sown area (millions of hectares)	113.0	134.4	119.0	94 9	128.0
B. Production of grain (millions of tons)	73.3	69 9	95.3	65.9	87.2
C. Production of cotton (millions of tons)	.82	1.3	154.9	66.5	171.6
D. Agricultural machinery in use (billions of roubles)	1.1	2.4	218.2	—	—
E. Tractors (thousands)	26.7	148.0	554 3	—	—
F. Tractors (thousands of horse power)	278 0	2225.0	800.4	—	—
G. Number of state farms (thousands)	3 1	10 2	326 4	—	—
H. Sown area of state farms (millions of hectares)	1.7	13.6	781.3	309.1	—
I. Number of collective farms (thousands)	33.3	209.6	629.4	—	—
J. Percentage of peasant households collectivized	1.7	61.5	3617.7	640.6	—
K. Sown area of collective farms (millions of hectares)	1 4	91 6	6684 5	631.7	—

[a] Sources: *Handbook of the Soviet Union*, pp. 69–70.

level changes and consequently represent the actual results obtained.

The Second Five-Year Plan.—The second Five-Year Plan, which was to run from 1933 through 1937, outlined another ambitious economic program for the U.S.S.R. The plan was declared completed by April 1, 1937, nine months ahead of schedule. In Table 28, we present statistics which show estimated

TABLE 28.—ESTIMATED PRODUCTION IN IMPORTANT RUSSIAN INDUSTRIES IN 1937, AS COMPARED WITH RUSSIAN PRODUCTION IN OTHER YEARS, AND WITH PRODUCTION IN THE UNITED STATES IN 1937[a]

Type of Production	1913	1928	1932	1937 (estimates)	1942 plan	U. S. 1937 (estimates)
Pig iron (millions of tons)	4.2	3.4	6.2	16 0	32 to 36	40
Steel (millions of tons)...	4.2	4 3	5.9	20 1	40 to 41	52
Copper (thousands of tons)	30 0	25 3	46.0	149 0	300 to 400	960
Coal (millions of tons)...	29.0	35.8	64.3	152 5	250 to 300	500
Oil (millions of tons) ...	9 5	11.5	22.3	34 5	—	188
Electric power (billions of kilowatt hours)... ..	1 9	3.0	13 5	40.5	100	118
Automobiles (thousands).	None	0.8	23 9	220 0	725 to 750	5000
Tractors (thousands) ...	None	27.0	51.6	66 0	100 to 125	295
Locomotives (units). . .	600	480	829	1425	—	450
Cotton (millions of bales)	1.1	1.2	1.8	3.4	5.4	18.5

[a] Source: *Business Week*, October 30, 1937, pp. 16–18.

production results in several important lines of Russian industry in 1937. These figures are compared with production at the completion of the first Plan in 1932, with production in 1928 prior to the adoption of the first Plan, with production in 1913 before the World War, with expected production in 1942 under the third Plan, and with estimated production in the United States in 1937. As before, however, we must caution the reader that the Russian statistics given are those published by that country, and that their strict accuracy cannot be guaranteed. The goals for 1942 would seem to be extremely ambitious, and it remains to be seen whether they can be reached or even approximated.

Table 29 shows that various lines of Russian production have improved their positions in world output under the first two Five-Year Plans, and compares the percentage increases in these Russian industries with the percentage increases for the world as a

TABLE 29.—PROGRESS IN RUSSIAN PRODUCTION UNDER THE FIRST AND SECOND FIVE-YEAR PLANS[a]

Commodity	Position of Soviet Union in World Production		Percentage of Increase in Output, 1927–36	
	1927	1936	In U.S.S.R.	In World
Coal	7th	4th	270	3
Pig iron	6th	3rd	374	6
Steel	5th	3rd	325	24
Electricity	10th	3rd	500	50
Oil	2nd	2nd	150	40
Cement	8th	4th	250	8
Paper	11th	6th	130	20
Cotton (ginned)	4th	4th	250	33
Rayon	18th	9th	5500	330
Aluminum	(1932) 11th	3rd	3300	70
Gold	5th	2nd	600–700	100
Motor cars	10th	6th	13,600	40

Commodity	Position of Soviet Union in World Production		Percentage of Increase in Output, 1925 to 1935–6	
	1925	1935–6	In U.S.S.R.	In World
Wheat	2nd	1st	45	2
Barley	1st	1st	42	8
Rye	1st	1st	3	—
Oats	2nd	1st	38	1
Potatoes	1st	1st	65	7
Beet sugar	(1927–8) 4th	1st	109	19

[a] Source: *Business Week*, October 30, 1937, pp. 16–18.

whole. While it was intended that the production of consumers' goods should get much more attention under the second than under the first Five-Year Plan, it should be said that, in actual practice, the chief emphasis under the second Plan, as under the first, was upon extending the foundations of the Russian industrial structure rather than increasing the output of consumers' goods. Hence, while industrial production at the end of 1936 was four times the 1929 output, and seven times that of 1927, standards of living for consumers were still very low. In 1937, it was reported that a pair of shoes or a suit of clothes of fair quality

cost the equivalent of four months' wages for ordinary workers, while the purchase of a shirt took a week's wages.[7] However, rents were reported to be exceedingly low, and to vary with wages. Bread and vegetables were cheap, and good meals were available at low prices for workers in factories. Moreover, workers enjoyed the advantages of cheap travel, free vacations, free medical care, and an extensive social security program. Under the third Five-Year Plan, consumers are expected to receive greater benefits than before from the great industrial structure that has been built up in Russia.

The Distribution of Income.—While Russia has not succeeded in distributing income according to needs, or even on the basis of strict equality, she has been able, by eliminating the private ownership of land and capital and by setting rather sharp limits to wage differentials, to achieve a distribution of income in which inequalities are slight, as compared with the economic inequalities of capitalistic countries. As we saw in previous chapters, many evils may arise from excessive inequalities in income, and much may be gained by reducing inequality. Indeed, it is probable that a given national income, well distributed, would provide much more human satisfaction than a considerably larger income which is poorly distributed. This point of view is often advanced by the Russians when the prospective efficiency of their economic system is brought into question. They argue that it is relatively easy for one to get along on a rather small income, so long as there are few who have larger incomes, and none who have incomes that are much larger.

The Elimination of Depressions.—Supporters of the Soviet régime are fond of referring to the U.S.S.R. as "the land without depressions," and in general its claim to this title seems to have some justification—although some critics are so unkind as to say that the absence of cyclical business fluctuations in Russia indicates merely that the country is in a state of perpetual depression. But whatever the level of economic activity may have been in Russia, it seems clear that this activity has not thus far been characterized by any of the business breakdowns which occur at frequent intervals in capitalistic countries.

This does not mean that instability of economic activity is impossible in Russia, and that business depressions or breakdowns could not occur there under any circumstances. It does mean, how-

[7] *Ibid.*, November 13, 1937, pp. 523-526.

ever, that if the Soviet system is well managed and if the desire to eliminate business depressions is sufficiently strong, Russia is in an advantageous position for maintaining economic stability. She is in a position, as we have seen, to avoid many of the types of waste which ordinarily characterize capitalistic states. Production is planned and controlled by society as a whole through governmental agencies and is not dependent, as in capitalistic countries, upon the decisions of thousands of independent and uncoordinated individuals. As a result, misdirected production should be less likely to occur in Russia than elsewhere. Of course, the planning authorities have to plan production for future markets, and it is likely that mistakes will be made in estimating consumers' needs or demands. However, since they are in a position to control prices as well as other economic matters, it will be possible to prevent such mistakes from clogging the markets with unsalable commodities, especially since it is not necessary in Russia for any particular commodities to sell at profitable or cost-covering prices.

Finally, the conflict between individual and social interests has been minimized in Russia. Economic activity is carried on in the interests of society as a whole, and its object is to produce goods in abundance rather than at a profit. In other words, there are no private enterprisers in Russian industry whose doubts and fears might at times lead them to restrict production, throw laborers out of work, and cut down their purchases of materials and supplies, because of a current or prospective lapse of profits. It is to the interests of Russians as producers to keep the wheels of industry turning just so long as it is to the interests of Russians as consumers to have the goods that are thus made available.

The Employment of Labor.—Russia also likes to be known as "the land without unemployment." Indeed, the national constitution now promises every person a job. In the past, some Russians have been excluded from employment in socialized industries because of their connection with the old régime, but this policy is to be discontinued. Certainly, Russia has had but little unemployment in the past. However, it must be noted that there is nothing about the Soviet system which inevitably rules out unemployment. But it seems probable that the planning authorities can prevent unemployment if they devote themselves to the task with wisdom and determination.

In capitalistic societies, laborers are put to work by the business

enterprisers, who control the land and capital, only if it appears likely that profits can be made in this way. In the U.S.S.R., laborers work for the government—that is, for society as a whole—and it is profitable for society to put people to work just so long as human wants remain unsatisfied. In Russia, the question of profit from the employment of labor does not arise in the usual sense. The cost of putting additional laborers to work consists of turning over to these workers certain productive resources which could otherwise be used by laborers already at work. In other words, the cost of employing more labor is the necessity for those already at work to get along at least temporarily with smaller real incomes. But this reduction in real incomes for those previously employed will be merely temporary, unless the population of the country should become too large in comparison with the land and capital at its disposal. And even in this event, it would be both possible and desirable to keep at work all who are capable of contributing to production.

Criticisms of Russian Achievements.—It is not intended that this discussion should give the impression that no problems remain unsolved in the U.S.S.R. Some critics, while conceding that rapid economic progress has been made, are inclined to discount this progress because of the low level of economic activity from which the planned economy started. It is obviously much easier to double a small national income than a large one. An absolute increase which would double the number of industrial workers employed in Russia might cause only a ten-per-cent increase in the number employed in this country. It has been suggested that economic progress in Russia under planning has proceeded but little, if any, faster than American economic progress in the early days of this country, if allowance is made for differences in the conditions under which the progress occurred. According to this analysis, economic activity in Russia will expand much more slowly in the future than in the past.

The Success of Planned Production.—It may also be contended that Russia has not yet given convincing proof of success in adapting planned production to human desires. Despite all the gains that have been made, standards of living are still very low in Russia as compared with the leading industrial nations. With the people in sore need of goods of almost all kinds, it has been easy for the planning authorities to direct production so that the goods produced would be wanted by consumers. When Russian

productivity has advanced so that the basic wants of the people have been cared for, the problem of turning out the kinds and quantities of comforts and luxuries that people desire will be a more difficult matter. The real test of planned production in satisfying the desires of consumers is still to come.

The Question of Incentives.—Critics of the Russian system also aver that it has been slow to show increases in efficiency. Great increases in physical productivity have occurred, of course, but it is contended that quality has not been significantly improved nor costs of production greatly reduced from their extremely high original level. Increased production is said to have resulted from the use of additional agents of production, rather than from increased efficiency in the operation of existing facilities. The bureaucratic control of industry is said to have led to mismanagement, serious delays, and maladjustments between different parts of the economic machine, while wastage and spoilage of materials by workers is said to remain excessive. If these difficulties are temporary in character, they may perhaps be attributed to the rapidity of industrialization in Russia and to the fact that millions of people with no previous industrial experience have been trying to learn quickly the mysteries of operating modern industrial equipment. But if they should prove to be permanent in character, they may indicate the existence of a serious defect in the Russian scheme of things.

We have seen that the distribution of income in the U.S.S.R. has been controlled in such a way that there is but a slight degree of economic inequality. This control of distribution is quite desirable from several points of view, but incomes must not be made so nearly equal as to destroy individual incentive to efficiency. Why should a laborer work hard and develop maximum efficiency if he will get the same, or very nearly the same, wage as the worker who toils just enough to hold down his job? Will people be anxious or even willing to take difficult and responsible managerial positions in industry if they receive in such posts an income which is only moderately higher than that received by ordinary labor? Will those in managerial and executive positions operate their plants with the utmost efficiency if they can get the same, or almost the same, income by operating only efficiently enough to avoid censure or punishment? Will they devise new processes and better methods of production if these achievements cannot result in profit to themselves? Will people of inventive

talent exercise their genius if their inventions benefit them only indirectly through the increased productivity of society?

Many people feel that Russia has limited inequality in the distribution of income to such an extent as to destroy or greatly weaken individual incentive. The individual is allowed to gain only as society gains, and not as the direct result of his own effort and initiative. The hard work and efficiency of some may easily be offset by the laziness and inefficiency of others, with the net effect of no gain for society as a whole or for the hard-working and efficient individuals. Under these conditions, it is held that neither the interest of the individual in the welfare of society nor his fear of censure and punishment will bring about high efficiency in the absence of economic incentives. On this question, the future experience of the U.S.S.R. will doubtless throw much light.

The Question of Individual Freedom.—And finally, even if economic progress in Russia continues and her people are eventually better off in a material sense than the citizens of other countries, there will always be some to say that the Russians have purchased economic welfare at too high a price. In Russia, the interests of the individual have been largely subordinated to those of society. Economic activity has been regimented and controlled by the government. The institution of freedom of enterprise, cherished in capitalistic countries despite the fact that it means little to many citizens of these countries, has been done away with in the U.S.S.R. Competition, which is often called the life of trade, is no more. The chance to start out poor and wind up rich does not exist. Under such conditions, say the rugged individualists, life would not be worth the living for anyone of ability and initiative, despite the assurance that the government would provide a fairly good real income. This question of the relative merits of individual freedom and economic welfare is, of course, one which every person must answer for himself. And in the case of many persons, the decision will doubtless be withheld until they are in possession of more complete information regarding the long-run success of the Soviet movement.

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1. What is the importance, to students of economics, of examining the operation of the Russian planned economy?
2. Explain the organization of the Communist Party, and its importance in Russian political and economic affairs.

3. How did the old Soviet governmental organization in Russia differ from that provided for in the new constitution? Explain.
4. What were the principal peculiarities of the political system in Russia prior to 1936? How have these matters been altered by the new constitution?
5. How have the rights of individuals been changed by the new constitution?
6. How is industrial production planned in the U.S.S.R ?
7. What is meant by saying that industrial planning and control are conducted in both physical and financial terms in Russia?
8. Is the relationship of prices to costs of production a significant one in the Soviet economy? Explain.
9. Are there reasons for hoping that planned production can be adapted to the wants of consumers in Russia? Explain.
10. How does the status of agriculture differ from that of industry in the U.S.S.R.? Explain.
11. How do state farms, collective farms, and individual peasant farms differ in organization and operation?
12. What is the relative importance of each of these types of farms?
13. How are supplies of land and capital apportioned among the various industries in Russia?
14. How is the total volume of saving and investment controlled in the U.S.S.R.?
15. How is the Russian labor supply distributed among the various occupations and industries?
16. Why are differences in wages permitted between workers in Russia?
17. How great are these wage differences? Explain.
18. Explain the various ways in which consumers' goods have been distributed among the consumers in Russia.
19. What recent change has occurred in this connection, and what is its significance?
20. How is international trade handled by Russia?
21. How does the monetary problem in Russia differ from that faced by the governments of other countries? Explain.
22. Was the first Five-Year Plan successful? Explain.
23. Compare the results of the second Five-Year Plan with those of the first.
24. Discuss the changing position of Russian industries in the field of world production.
25. Have Russian consumers benefited greatly under the first and second Five-Year Plans? Explain.
26. Is Russia "the land without depressions"? Why?

27. Why is it said that unemployment can be avoided in Russia, if the authorities wish to avoid it?
28. On what basis are the accomplishments of the Russian planned economy often criticized?
29. State the problem of providing incentives to efficiency in Russia.
30. Have the Soviet authorities found a solution to this problem?

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26 FASCISM IN ITALY AND GERMANY

IN OCTOBER, 1922, BENITO MUSSOLINI DIRECTED THE FAMOUS FASCIST "MARCH ON ROME." SINCE THAT TIME, FASCISM IN ITALY has shown signs of becoming a relatively permanent system, so that we may well examine it in some detail and compare its essential features with those of our own political and economic system, and of Soviet Russia, as described in the preceding chapter.

The Italian Political System Under Fascism

In popular discussions and writings that appear in the United States, fascism is often confused with socialism and communism. Indeed, certain officials in American public life have at times been called both fascists and communists, in the same breath, by their political opponents. While it is hardly possible for anyone to be both a fascist and a communist at the same time, it is true that, in the past, there have been sufficient points of similarity between the Italian and Russian systems to lead to the false conclusion that they were well-nigh identical systems. Under the new Russian constitution, many of the old points of similarity are supposed to have disappeared.

The Italian Dictatorship.—Russia and Italy have been alike, in the first place, because both have had extremely strong central governments which controlled the economic and many other activities of their citizens. Mussolini was summoned by the King, soon after the march on Rome, to form a cabinet for the Italian government, and he has since been a supreme dictator, ruling the Italian people with an iron hand. Besides being Prime Minister, he holds several other important portfolios in the cabinet, and has turned the others over to trusted associates. He is President of the Grand Council of the Fascist Party, a body which acts in a consultative and advisory capacity on a wide variety of political, economic, and social matters. He alone can convoke the Grand Council and direct its activities. He is also the Minister of Corporations, and President of the National Council of Corporations

which has considerable power in directing the economic life of the country. In a word, Mussolini is, to all intents and purposes, the Italian government.

However, the King of Italy has been retained as the nominal head of the government, though in reality he holds no important powers. The Senate and Chamber of Deputies, the legislative bodies of the old system, have also been retained, but they too are powerless. They meet merely to approve promptly and automatically the acts and policies dictated by Mussolini. Candidates for the Chamber of Deputies are nominated by the Grand Council of the Fascist Party, and the people must vote for these candidates or not at all. Italy, like Russia, follows the industrial, rather than the geographical, principle of representation in the Chamber of Deputies; but it is clear that the members of this body are not representatives of the people in the ordinary, democratic sense. The Grand Council also has the power to draw up a list of candidates to succeed Mussolini, when a successor becomes necessary, and the King will select the successor from this list. Thus, it is intended that control of the government shall remain in the hands of the Fascist Party even after Mussolini has passed from the scene.

The Fascist Party.—Italy and Russia have been alike, also, in having a one-party system of government. We have seen that fascists fill all important positions at the head of the Italian government. In addition, the various minor governmental positions throughout the country are held by fascists and these posts are filled by appointment and not by election. No other political parties or organizations are tolerated, and no one who is not a fascist can hope to hold governmental offices.

The Fascist Party, from its small beginning following the World War, has a membership of some 2,500,000 adults. Except by special permission from above, the party does not accept new adult members. Instead, it relies upon the development of new members from the junior fascist organizations. Boys between the ages of 8 and 14 receive both fascist and military training, while youths from 14 to 18 years of age may be members of the Avanguardisti of the Fascist Party. Comparable organizations exist for fascist girls. Especially favored youths are permitted to join the Volunteer Militia for National Security, which is in effect a fascist private army or police force. Several millions of budding fascists are found in the various youth organizations.

The Secretary of the Grand Council nominates, and Mussolini appoints, the Secretaries of the Provincial Federations of the Fascist Party. In like fashion, district and local party officials are appointed from above, so that control over the party organization is maintained directly from top to bottom. The principal requirement for membership in the Fascist Party appears to be a willingness to obey Mussolini's orders without question and a determination to serve the party's cause without reservations. As in the case of the Communist Party in Russia, members of the Fascist Party are carefully watched after being admitted to membership, and may be called to account at any time if they fail to exhibit the prescribed fascist virtues.

Individual Liberties.—Italy under fascism is like Russia in that the rights and liberties of the Italians as individuals have been almost entirely destroyed. Fascism has a profound distrust of democracy, and feels that democratic institutions are out of place in a truly modern state. Ordinary individuals are considered too ignorant or too thoroughly immersed in the private affairs of life to carry on the affairs of government successfully. This task must be undertaken by the chosen few, who are found in the Fascist Party. The right of free assembly is denied except to fascist organizations All newspapers and other publications opposed to the rise of fascism have been ruthlessly suppressed. The publications that remain print only what they are told to print. Freedom of the press is a meaningless term in Italy. Freedom of speech is also practically non-existent there. Any criticism of, or opposition to, acts and policies of the government or of the Fascist Party is likely to be interpreted as treason. Those accused of such political offenses are tried by fascist judges, and are often not even granted the right to hire lawyers to represent them. Education is rigidly controlled by the government for the purpose of perpetuating the fascist régime. Not only is opposition to fascism viewed as a kind of social disease which must be eradicated as quickly as possible, but the favorite method of eradication is that of violence. Sluggings, beatings, and other forms of mob violence, as well as overdoses of castor oil for those who fail to see the light of fascism, have done much to discourage outward show of opposition to fascism.

The Individual and the State.—Though both Italy and Russia have had very strong central governments to which the individual has been subordinated, there are in this connection

two important points of difference between the countries. In Russia, the dictatorship has been that of the proletariat, or industrial workers. Fascism, in its formative stages, was supported largely by landowners, industrialists, and the middle classes in general. Indeed, socialists and communists usually look upon fascism as an instrument for controlling and suppressing the workers in the interests of the owning classes. Whether the Italian middle classes have actually received from fascism the benefits which they expected is a debatable point, as we shall see later, but there can be little doubt as to the origin of the original support of the fascist movement.

The second point of difference between the centralized control in Italy and Russia is this: The individual in Russia has been subordinated to the state for his own good, because it was thought that this was the way in which the greatest good would come to the greatest number. In Italy, however, the individual has been subordinated to the state for the good of the state. The state is thought of as something more than an aggregate of the individuals who make it up at any particular time. "For fascism, society has historical and immanent ends of preservation, expansion and improvement, quite distinct from those of the individuals which at a given time compose it; so distinct in fact that they may even be in opposition."[1] Individuals are regarded as merely the means by which society may reach its goal, and as but temporary and relatively unimportant elements in the long life of the state.

Moreover, the individual cannot exist without the state. Apart from the state the individual has no more purpose or reason for being than has one body cell isolated from the human body. For the individual to assert his rights against the state would be as ridiculous as for a body cell to rebel against the body as a whole. Thus, the individual has no rights which are superior to those of the state. He has merely a duty toward the state and, in performing this duty, he may be expected to sacrifice everything, even life itself. The interests of the state permeate all activities of the individual, and not merely his political activities. This general theory explains why the rights of individuals, as we are accustomed to view them, are largely suppressed in Italy. The fascist theory of the state is seen in action in the economic policies of fascism, most of which are intended to promote the greater glory

[1] Julia E Johnsen, compiler, *Capitalism and Its Alternatives,* New York, H W. Wilson Company, 1933, p. 376.

of Italy, rather than the welfare of the individual citizens of that country.

ECONOMIC POLICIES OF ITALIAN FASCISM

The Question of Economic Planning.—The question of whether Italy under fascism engages in national economic planning is one which requires careful consideration. Some writers say that a nation engages in economic planning whenever the government interferes with and controls economic activity to any considerable extent. In this sense of the term, Italy engages in economic planning, for the government does exercise a considerable degree of control over economic activity. However, if true economic planning involves drawing up detailed plans for all departments of economic activity over a considerable period of time, with supplementary detailed estimates of proposed achievements in a given year, Italy does not have economic planning. In other words, if Russia provides an example of a planned economy, Italian economic activity is not planned but merely controlled.

In Italy—contrary to the situation in Russia—land and capital are largely owned by private individuals who, without working, may receive incomes in the form of rent or interest. As was suggested in an earlier chapter, effective national economic planning is most difficult, even under a dictatorship, so long as the basic means of production are privately owned; for it is hard, under this condition, to eliminate all conflict between individual and social economic interests. Instead of having all branches of economic activity directed by the state, fascist Italy recognizes that private initiative in production is an effective and economical instrument for getting things done. However, those who direct economic activity are said to be responsible to the state, for the interests of the state are supreme. The state is supposed to interfere in the field of production only when private initiative is lacking or inadequate, or when the interests of the state are so directly concerned as to make governmental control imperative. Interference by the government may take the form of encouragement, general supervision, or outright management.

Fascists are said to be proud of the fact that fascism has no general program, save that it intends to promote the greatness of Italy. Fascism concentrates upon action, rather than theory. According to Mussolini, fascism as an idea is indefinable. It is a fact which is taking place. Thus, fascism has no instruments for

economic planning in a comprehensive sense, and only Mussolini, indeed, has the power to plan in any real sense of the word. His policies in controlling economic activity are sporadic and likely to affect only certain phases of economic activity at any one time. Thus, at a time when war seems to be in the offing, Mussolini is likely to order certain essential industries to run day and night until further notice, in order to increase production. At other times, when he decides that it is desirable to maintain the Italian monetary unit, the lira, at an artificially high value in terms of the currencies of other countries, he may order a general reduction in prices and wages throughout Italy, and see to it that the order is enforced.

To be sure, the Italian government owns and operates the railroads, much of the shipping industry, the post office, the telephone and telegraph business, and the industries producing salt and tobacco. This, however, is a far cry from the situation in Russia, where practically all industries are owned and operated by the government. Mussolini has also been able to achieve a crude sort of control over the kinds and quantities of goods to be produced in Italy, by taking over the investment banking activities of the country. The credit of the government has been made available for enterprises and industries which Mussolini has thought worthy of encouragement, while other businesses have been required to work out their own salvation.

The Making of Economic Decisions.—But when all is said and done, it must be evident that economic activity in Italy is to a considerable extent unplanned. Private individuals still own land and capital, and may turn over these agents of production to any enterpriser on the basis of the rate of return that is offered. Individuals are left free to save or not to save, on the basis of the usual economic incentives. Private enterprisers in many cases still decide for themselves what to produce and in what quantities, and are free to operate their enterprises at capacity, at part capacity, or not at all, in the absence of specific orders from the government. Individuals as consumers are left free, for the most part, to spend their money incomes in any way which seems desirable, and producers must rely upon the willingness of consumers to purchase their products at prevailing prices. While the government frequently interferes in these phases of economic life, the individual is assumed to be free unless and until he is specifically interfered with, while in Russia it is assumed that the government controls

and directs all economic life in the absence of specific information to the contrary.

Business Depressions and Unemployment.—Under the conditions just described, Italy is not in so favorable a position as Russia with respect to business depressions and unemployment. Since the control of production in Italy is left to private initiative, in cases where the interests of the state are not likely to suffer, and since private individuals have a stake in the profitable operation of industry, it is to be expected that Italian enterprisers will vary their rates of production in accordance with business conditions and the prospect of profit or loss, when not under specific orders from the government. Since most businesses in Italy are relatively small-scale enterprises, it follows that decisions in the field of production, when not controlled by the government, are made by a considerable number of independent individuals. Hence, the Italian system could hardly be expected to avoid the competitive wastes which characterize other capitalistic economic systems, and the cumulative mistakes which are so potent a factor in bringing about periodic business breakdowns or depressions. Moreover, since the Italian monetary unit was kept on a gold basis for a long time under fascism, the Italian economy has been subject to international influences when business has been depressed in other countries. For example, Italy was one of the countries affected by the post-1929 depression.

Unemployment has also been a problem in Italy, as in other capitalistic countries; for the basic means of production are privately owned, and the workers depend upon the owners for the chance to work. Except in industries controlled by the government, Italian business leaders, like capitalist employers elsewhere, employ labor when it appears that a profit may be made, and refuse to employ it when business conditions are unfavorable. When a government plans and directs all economic activity, there can be plenty of jobs for workers so long as human wants remain unsatisfied, but this is not the case in Italy. The official statements on the involuntarily idle claim that the number of unemployed, which had once reached 1,200,000, was reduced to fewer than 500,000 by 1937[2]—but this reduction, if it actually took place, probably resulted from increased preparations for war and the absorption of large numbers of men into the armed forces of the country, and not from an improvement in the general economic

[2] *Nineteenth Century Magazine,* April, 1938, pp. 420-434.

situation. Moreover, some people contend that the unemployment problem in Italy today is in reality more serious than it appears to be from the official statistics.

The Nature of the Fascist System.—We have said enough about the general organization of the fascist economic system to show that it is not a socialistic or communistic planned economy. Instead, the fascist system might be called a form of state capitalism; for the outward forms of capitalism are retained while the operation of the system is underwritten and controlled by the state in its own interests. We shall see, as we examine the specific economic policies of fascism, that they are seldom, if ever, policies which might be expected to enhance the economic welfare of the masses, except in so far as these people may derive a psychic income from the greater glory which may come to Italy as a nation.

Employer-employee Relations.—While the Italian government does not directly control the distribution of the national income among landowners, capitalists, enterprisers, and workers, the relations of capital and labor are controlled by a somewhat complex system under governmental supervision. The general outlines of this system are set forth in the Charter of Labor, which was promulgated in 1927 and is regarded by fascists as a kind of constitution for the development of the fascist ideal known as the Corporate State. Under the provisions of the Charter of Labor, wages, hours, and other working conditions are fixed by contracts between workers' and employers' syndicates.

The Syndicates.—The syndicate is the basic unit for the conduct of employer-employee relations. The state permits only one syndicate for each industrial category of workers or employers in a geographical unit; and syndicates of workers must be separate from those of employers. A workers' syndicate may be formed by as few as 10 per cent of the workers in an industrial category in a given locality, and, if approved by the government, may make contracts for all the workers. In like manner, an employers' syndicate may be formed by enterprisers who employ at least 10 per cent of the workers in an industrial category in a given locality, and who comply with certain other specified conditions. Labor contracts drawn up between these opposing syndicates are binding on all workers and employers in an industrial category, and non-members as well as members must pay dues to the syndicates. In addition to drawing up labor contracts, the

syndicates administer maternity benefits, vacations, insurance, medical attention, and other matters.

Local syndicates of employers and employees form into federations covering larger geographical areas, and so on up to national federations under the supervision of the National Council of Corporations and the Minister of Corporations. All employees come under one or another of the national federations for (1) industry, (2) agriculture, (3) commerce, and (4) banking and insurance. There are similar national federations for employers. In addition, there is a federation for professional workers, for which there is no corresponding employers' federation, since these professional people ordinarily work for themselves. In addition to this rather complete vertical organization of capital and labor—extending all the way from the local syndicates of workers and employers to the head of the government—there are two types of horizontal, or "crosswise," organizations. In each of the 92 provinces of the country is an organization known as the Provincial Economic Corporative Council, whose function it is to handle administrative difficulties at the provincial level and keep them from troubling the central governmental organizations. Twenty-two so-called corporations have been set up to deal with matters concerning specific branches of production such as cereals, wine, textiles, wood products, chemical products, paper and printing, and so on. These corporations supervise and try to raise the efficiency of the business concerns in their branches of industry, but do not actually operate these businesses.

The Labor Courts.—We have said that wages and working conditions are determined by labor contracts drawn up between syndicates of workers and employers, but there remains the problem of handling disputes between employees and employers as to the interpretation of an existing labor contract, or the desire of one group or the other to introduce new conditions which the other party does not favor. Fascism recognizes that there may be conflicts of interest between employers and employees, but it is determined that these conflicts shall not result in a cessation of production which might injure consumers and the interests of the nation as a whole. Consequently, under the Italian system, workers and employers are forbidden, under severe penalties, to engage in strikes and lockouts, or use any of the other weapons—described in Chapter 2—which employers and employees in most countries employ in attempting to enforce their demands.

When a dispute of some importance arises, an attempt is made to bring workers and employers together through conciliation. If conciliatory measures fail, the controversy must be submitted to labor courts. These courts have been set up in various districts throughout the country. Each court is composed of three judges, assisted by two experts, one on labor problems and the other on production. Decisions are rendered both on the basis of law and precedent, and in consideration of the interests of consumers and the nation as a whole. Thus, the interests of both employers and employees are supposed to be subordinated to those of society as a whole. Another labor device of the Italian system is found in the free labor exchanges. To these agencies the employer must go when he requires new workers, and even then he is not allowed to hire his workers directly. He merely states the number and kind of workers he wants, and they are furnished him by the exchange —preference being given to fascists over non-fascists in choosing men for jobs.

The Results of the Fascist Labor Policies.—In 1937, it was reported that the labor courts had, up to that time, decided in favor of labor 72 per cent of the disputes between employers and employees that could not be settled by direct negotiation. Thirteen per cent had been decided in favor of the employers, and the other 15 per cent of the cases were settled by compromise.[3] However, in spite of these reports, there is a widespread opinion that the fascist method of handling relations between employers and employees is likely to work to the disadvantage of labor. Under the system, workers and employers are given equal rights of organization and both are deprived of their usual weapons of industrial warfare. This equal treatment might be ideal, if the two classes had equal bargaining power in the first place. But since, other things being equal, employers are much superior to their workers in bargaining power, it would seem that the employers clearly hold the upper hand under this system of "equal treatment" for capital and labor. Both capital and labor are subjected to one-party political control, and it is held that the system tends to perpetuate existing labor conditions instead of improving them. It is also contended that the system tends to bring all workers, regardless of ability, to a single economic level. It is true, of course, that the loss to the nation as a whole, which would result from direct conflict between workers and employers,

[3] *Ibid.*, pp. 420-434

is reduced. But it is merely reduced, and not eliminated, for it must be remembered that disgruntled workers can "soldier on the job" even though they may not be allowed to go out on strike.

Fascist Finances.—Another fascist policy has been to stabilize the value of the monetary unit, the lira, and to keep it on the gold standard. During the World War, the value of the lira was kept quite stable at from 30 to 35 lire to the pound sterling. But after the war its value fell off rapidly until, at the time of the march on Rome, it stood at 116 lire to the pound sterling. Its value improved for a time after Mussolini came into power, but fell as low as 150 to the pound sterling in 1925 and again in 1926. In 1927, Mussolini stabilized the value of the lira, and put it on a gold basis at the ratio of 92.46 to the pound sterling.[4] To this policy Mussolini was determined to stick through thick and thin, but in 1936, after France went off the gold standard, Italy too was compelled to abandon it.

It is undoubtedly true that some advantages are derived by a nation from having a currency of stable value, in terms of the currencies of other countries. International trade is difficult to conduct when the value of a country's monetary unit fluctuates wildly in terms of the monetary units of other countries. Capital that is seeking opportunities for investment is inclined to shun a country whose monetary unit is unstable in value, and there is undoubtedly a certain prestige that attaches to the maintenance of a stable monetary unit. However, Mussolini has often been accused by critics outside Italy, of having stabilized the lira at too high a value in terms of gold and the monies of other countries. At any rate, the value set upon the lira in terms of gold was higher than its domestic value in terms of prices and wages.

As a consequence, in order to prevent the loss of the country's gold reserves, Mussolini was forced on more than one occasion to order a general reduction in prices and wages of (say) 10 per cent throughout the country. He would call upon the people as consumers to insist that business men lower their prices by the requisite amount. Of course, employers did not usually have to be urged to lower wages when this action was suggested by the dictator. With respect to prices, the government eventually specified the prices to be charged for certain economic goods, and closed down business establishments which did not adhere to these prices. When the great depression came in 1929, the deflation

[4] Luigi Villari, *Italy*, New York, Charles Scribner's Sons, 1929, pp 243-250.

which it caused was added to that necessitated by the monetary policy, and the result was great hardship for the Italian people. Mussolini, however, stuck to his monetary policy without seeming too greatly concerned over its effects on the welfare of individual citizens. It is said by some that the Italian people have been called upon to make greater sacrifices under fascism than the sacrifices demanded of the citizens of Soviet Russia.

With regard to other financial matters, Italy's experience in recent years has been similar to that of many other countries. The budget of the Italian government was out of balance in 1935 and 1936 to the extent of about 15 billion lire, while the national debt grew from 92 to 101 billion lire between 1934 and April, 1937.[5] The government has resorted to heavy borrowing, a capital levy on real estate and public companies, an increase in the turnover tax, and borrowing from the bank of issue on interest-bearing current accounts. On the other hand, Italy's external debt is small, and she has succeeded in reducing her unfavorable trade balance, though her balance of payments was still unfavorable to the extent of £15,000,000 in 1937.[5] These facts are not, of course, an indictment of Italian financial management under fascism, but merely indications that Italy is affected in the same way as most other countries by business depressions.

Economic Self-sufficiency.—Another policy upon which Mussolini insists is that of making Italy as nearly self-sufficient as possible, from the economic point of view. Self-sufficiency is very difficult for Italy to attain, because of her limited supply of poor, worn soil and other natural resources. Italy has building materials, sulphur, mercury, aluminum, zinc, and lead, but she lacks iron, coal, petroleum, copper, chromium, manganese, tin, and nickel.[6] Nevertheless, some progress is being made. In 1921, Italy imported about half of the wheat she consumed. After several years of the "Battle of the Wheat," as Italy's efforts to increase wheat production were somewhat dramatically called, her output of this grain was increased until now, in some years at least, she produces more wheat than Canada, and has to import but little. The Italians also manufacture synthetic rubber, cellulose (made from esparto grass, straw, and broom), and artificial cotton and wool (the latter being made from milk).[6]

[5] *Ibid.*, pp. 420-434.
[6] *Ibid.*, pp. 420-424.

Economic self-sufficiency is a policy which is conducted in the interests of Italy as a nation rather than of individual Italians as consumers. The cost of the policy in terms of standards of living is tragically high. The present volume of wheat production, for example, is obtainable only by carrying production far beyond the point of diminishing returns, both intensively and extensively. To justify this volume of production from a financial point of view, the prices of wheat and wheat products must be very high. The present import duty on wheat is 150 per cent *ad valorem*. That is, a bushel of wheat entering Italy from the United States at a cost of $1.00 would have a duty of $1.50 applied to it, making the total price to Italians $2.50. Such a duty is apparently necessary to keep foreign wheat producers from underselling Italian producers, and thus interfering with domestic production.

The injurious effects of such a policy upon consumers, when applied to a number of commodities, are obvious. Reports from Italy in 1937 told of a shortage of food products, especially of milk, butter, and cheese, while bread was said to be rationed at one kilogram (2¼ pounds) per day per family. Meat consumption, even in the more prosperous districts, was reported in 1937 to be only about 10 per cent as great as in 1933. One meal a day was customary in certain rural areas, and the people were compelled by hunger to gather every conceivable kind of edible herb. The soldiers, who at least are well fed, were said to be greatly annoyed at mealtimes by people who begged for food.[7] It is apparent, then, that standards of living in Italy are very low, despite the relatively favorable position of Italians with respect to certain public services and commodities, such as education, social insurance, medical care, recreation, electricity, roads and railways, housing, and water supply.

The self-sufficiency policy flies in the face of all that is known about the benefits of geographical specialization and exchange of products. It is a policy which is conducted primarily for military reasons. If Italy were dependent upon foreign sources of supply for essential commodities and these sources of supply were cut off in time of war, her situation might be desperate indeed. Rather than take a chance of this kind, Mussolini demands that the people make the sacrifices necessary to a policy of self-sufficiency, and the Italian people are apparently willing to make these sacrifices. We say "apparently" because, under present conditions, it

[7] *The Nation*, October 2, 1937.

would be dangerous for an Italian to appear unwilling to cooperate. In any case, since Italy is almost completely lacking in supplies of coal, iron ore, oil, and other essential resources, it is difficult to visualize the complete success of the policy of self-sufficiency.

The Population Policy.—The fascist policy on population, also, apparently is contrary to the interests of individual Italians as consumers. The population of Italy is already dense, averaging 344 to the square mile. In view of the small supply of poor, unproductive land and the scarcity of other natural resources, it would appear desirable, from the point of view of the welfare of Italian citizens as consumers, to check the growth of population rather sharply, particularly if Italy is to continue to try to satisfy the greater part of her wants through domestic production. However, Mussolini apparently feels the need of men for military purposes, and is doing everything within his power to encourage births and discourage emigration.

The Italian birth rate dropped from 39.3 per thousand of population in 1876 to 25.2 per thousand in 1929.[8] This must have been rather disconcerting to a man of Mussolini's militaristic inclinations. At any rate, Italy now encourages mass marriages, or marriages of large numbers of men and women at showy public services. Cash prizes for marriages, and other cash prizes for large families, are offered by the government. Married men are given first chance at government jobs and preference in obtaining housing. Extra high taxes are levied on bachelors, and the government provides a three-year food allowance for unmarried mothers. Despite all of these policies and the strict limitation of emigration, the Italian population has not been increasing as fast as desired; for the ratio between births and deaths was 23 to 13 per thousand in 1937, as compared with 30 to 18 in 1922, at the time of the "March on Rome."[9]

Fascist Militarism.—Another outstanding feature of fascism is its strongly militaristic attitude. According to Mussolini, war is not only necessary, but desirable, and a large part of Italian resources is devoted to maintaining the military establishment. The Italian armed forces are very large in proportion to the population, and their maintenance places another heavy burden upon the citizens as consumers. Children begin to receive military

[8] *Fortune,* July, 1934.

[9] *Nineteenth Century Magazine,* 1938, pp. 420-434.

training almost as soon as they are able to walk, and are trained to expect and desire warfare. Mussolini has hurled countless warlike threats and challenges at prospective enemy countries, and has reiterated his opinion that Italy, with her dense population, must either "expand or explode." One such expansion took place recently in the Italian conquest of Ethiopia, which was described in another chapter; and serious conflict with more powerful adversaries may occur at any time.

The Results of Fascism.—As we have seen, most of the policies of Italian fascism are intended to increase Italy's greatness and prestige among the nations of the world rather than to enhance the economic welfare of Italian citizens as consumers. As a result, economic welfare has decreased, and not increased, under fascism. Wages and standards of living in Italy were always about as low as any in Europe, and they have fallen to undisputed last place under fascism. Basic wages for labor have recently been as low as eight cents an hour. Bankruptcies have increased many-fold under fascism. Moreover, the revenues of the government have depended very largely upon indirect (or consumption) taxes, which burden the poor relatively more heavily than the rich. The income tax yields only about 20 per cent of the government's tax revenues, and has the added disadvantage of beginning with very small incomes and providing comparatively low rates on incomes in the higher brackets.

Of course, it may be argued on behalf of fascism that it "works." The Italian people are quiet, they work without strikes, they eat quite regularly, if not heartily, and those in control of the economic system are presumed to act solely for the best interests of the citizens. However, as an English writer puts it: "In England we have places in which the food comes regularly, where the people are quiet, where they work without strikes, and where those in control act solely for the best interests of those whom they control. We call those places prisons. They are said to be good for the prisoners; but the prisoners are not asked for their views!"[10] Fascists tell us that other countries, like the United States, have much to learn from fascism. This may be true in a negative sense. It is quite possible that the lesson to be learned from fascism is not what to do, but what *not* to do, about our economic problems.

[10] Cecil Delisle Burns, quoted in *Capitalism and Its Alternatives*, p. 412.

The German Fascist State

Germany is another great country which is now operating under a system of fascism, though the German system is officially called Nazism or National Socialism. It would be a mistake to think that National Socialism is an exact replica of Italian fascism, but it resembles the latter in many external features and is more like fascism than any other system. We shall point out the essential similarities and differences of the two systems in describing National Socialism.

The German Dictatorship.—The present German system is like the Italian in that it has a very strong central government which exercises rigid control over all the activities of individual citizens. The head of the government is Adolph Hitler, who was appointed to the office of Chancellor (Prime Minister) by President von Hindenburg in 1933. Since that time, Hitler has in fact been the supreme dictator or "leader," as he is called, of the German people. However, whereas in Italy the fascist system has retained and will continue to retain the King as the nominal head of the government, the office of President has not been filled in Germany since the death of von Hindenburg and probably will not be filled. Like Mussolini in Italy, the German dictator is independent of Parliament, has absolute power to determine the formation of the Cabinet and the work and legislative activities of the Parliament, and may make laws by proclamation without action by the Parliament.

The National Socialist Party.—Germany, like Italy, has a one-party system of government. The National Socialist (or Nazi) Party is supreme, and other political organizations are sternly suppressed. Members of the party hold all major and minor governmental positions and get their posts by appointment from above, and not by election. While elections in general have been suspended, the people have an occasional chance to indorse the dictator's policies—being given a ballot with a large circle for voting "Ja," and a very small circle for voting "Nein." The National Socialist Party began to function in a small way several years before its accession to power, and now numbers several million members. Like the Italian Fascist Party, it now has organizations of young people, from which it will obtain members in the future. The principal requirement for membership appears to be a willingness to obey blindly and without question all wishes

or orders of the dictator. As in other one-party countries, the Nazi Party holds periodical purges by means of which it eliminates (by death or imprisonment) any elements in the party which may have become obnoxious to the leader.

Individual Liberties.—The National Socialist Party, like the Italian Fascist Party, regards democracy as useless and an evidence of weakness on the part of a nation, and finds it desirable to suppress all rights and liberties of individuals. Freedom of assembly does not exist outside the all-powerful party. Freedom of speech has been abolished, and the press is entirely controlled by the government, printing only government approved "news." Education is strictly controlled by the government, in order that the principles of National Socialism may be inculcated in the youth of the land. Even religion in Germany has become largely a function of the ruling party. Religious leaders have been displaced by other persons who will be amenable to the wishes of the party and will preach National Socialism, and it is reported that the Bible is being rewritten to conform to party principles. In Italy, the Catholic Church continues to function on the basis of an agreement with Mussolini, although its relations with the government are not particularly cordial.

In Germany, a man's house is not his castle if we may believe the critics of National Socialism. A citizen's house may be invaded and his personal possessions destroyed at any time by governmental representatives acting without warrant. He may be arrested without warrant, tried without jury or legal representation, and given an exceedingly severe sentence. The law is whatever the leaders say it is. It may be one thing today and quite another tomorrow. A man may be punished for an action which was not a crime or misdemeanor at the time at which it took place. He may be punished for crimes which it is presumed he will commit in the future, and for offenses which others may conceivably commit against him—this last type of punishment being called "protective arrest." He may be confined without specific charges being lodged against him. He may be arrested and punished merely for stating that a crime has been committed—the name for this offense being "the spreading of atrocity legends." Moreover, the German people are subjected to espionage on the part of the government to an extent which has probably never before been equaled in peace times. Such are the ac-

counts of the status of the individual under National Socialism, as reported by persons who have escaped from the country.

The Suppression of Opposition.—The National Socialist Party has emulated the Fascist Party of Italy in conducting a campaign of violence and terrorism against its opponents. In addition to those who have been killed or maimed, many thousands have been thrown into prison, or into concentration camps similar to the camps maintained for prisoners in time of war. In Italy, the intent of the government has been to subdue opposition elements, but to retain them in the population as useful members of society. In Germany the intent has been to exterminate the trouble-makers whenever possible.

Another difference suggests itself. In Italy, it was felt that opposition must be suppressed for the good of the state. In Germany, however, the good of the state is synonymous with the good of the race. According to the party program, none but members of the nation may be citizens of the state, and none but those of German (or Aryan) blood may be members of the nation. No Jew, therefore, may be a member of the nation. Much of the program of Nazi persecution and terrorism has, therefore, been directed against the Jews. The Germans are said to be psychologically powerless to admit that the loss of the World War and the unfortunate economic conditions which followed were due to any faults of their own. They hold that the World War was lost because of the treachery and duplicity of the Jews at home, and that the Jews were responsible, also, for the unfavorable economic conditions of the post-war years. Moreover, economic recovery and prosperity are said by the proponents of anti-Semitism to wait upon the elimination of the Jews from the population.

According to Jewish refugees from Germany, it is impossible to describe briefly the treatment to which the Jews have been subjected in Germany under National Socialism. They have been deprived of citizenship and the right to vote. They have been cast out of the professions, such as teaching, medicine, journalism, and the law. They may not belong to labor unions, or work in retail and mercantile fields. Their property has often been confiscated, and they themselves are subjected to close espionage. The rights of their children to education are curtailed, as is also their right to make a livelihood through the use of land. They have suffered personal indignities and physical violence, and severe

injury or death has been the portion of many. Some of the more fortunate have been able to flee the country, but those who remain are said to live in a constant state of terror and abject misery.

In Italy the campaign of suppression has been directed chiefly against living persons, and especially against those in Italy at the time, but in Germany the works of famous German writers of the past and of citizens of other countries have been condemned by the National Socialists. Such works have been banned from circulation, and have been burned in monster bonfires staged for this purpose. Objectionable paintings have been removed from art galleries, and other works of art destroyed. Even the performance of musical compositions by certain composers has been forbidden. The National Socialists have decreed that the German nation or German race shall work out its own art and culture, so that they may be free from alien contamination.

The supporters of National Socialism are, of course, much incensed by the reports of persecution and violence which come out of Germany. They insist that these reports are no more true than were those of atrocities committed by Germans during the World War, and that Germany is merely following a necessary and orderly policy of purifying the race and removing alien and discordant elements for the good of the nation. However, it would seem that these recent reports have appeared under circumstances much different from those of the war-time propaganda. It also appears that the program of persecution is still going on. How else shall we explain the disappearance of numbers of Germans who vanish completely, leaving no trace, the large number of "suicides," the high mortality due to pneumonia and other "natural causes" in jails and concentration camps, and the number of persons whose exit from this life is described as resulting from having been "shot while trying to escape"?

The Individual and the State.—The German and Italian systems are alike in other respects. Hitler, like Mussolini, derived much of his original support from capitalists, industrialists, and landowners, while workers were slow to join the movement. It is uncertain whether the original supporting classes have derived the benefits which they expected. In both Germany and Italy, the individual is not subordinated to the strong central government for his own good, but rather for the good of the state—or, in the case of Germany, for the good of the race.

Finally, the fascist theory of the state is reflected in the economic policies which are followed in Germany, for most of these policies are aimed at promoting the power and prestige of Germany rather than providing for the economic welfare of individual citizens.

ECONOMIC POLICIES OF GERMAN FASCISM

The Question of Economic Planning.—As for economic planning, it may be said that Germany has engaged in such planning only in the Italian, and not in the Russian, sense. Leaders of National Socialism have frequently stated that they do not intend to set up an economic system like that of Russia, in which the state owns and operates the basic means of production and individual initiative is destroyed. On the other hand it is certain that, in Germany, the power of government, and of the dictator, to interfere with and control economic activity extends to all branches of such activity. The German leaders say, however, that the German system is not intended to be permanently even a governmentally controlled system. The government does not propose to direct industry and trade in the long run, but intends merely to "open up the way" for private industry and trade. The influence of the government has been so extensive and pronounced thus far only because the Germany economy has been going through a period of emergency and reorganization. The validity of these contentions remains to be established. For the present, Germany appears to be a state in which economic activity is strongly *controlled* by the government, even if it is not thoroughly and comprehensively *planned* as in Russia.

To be sure, Germany is now well along in what is called a Four-Year Plan for German industry, but this has turned out to be a scheme for increasing the economic self-sufficiency of the country, rather than a comprehensive economic plan. This, too, is a policy which is followed in Italy. The reasons for adopting the policy in Germany are reasonably clear. In the years following the World War, Germany, being deprived of her colonies, was forced to depend upon other countries for large quantities of foodstuffs, and raw materials for her industries. These had to be paid for, and in addition Germany was required to make large payments to other countries on account of reparations. As we saw in another chapter, Germany was able to make these payments for several years only by borrowing very heavily in other coun-

tries. In the post-1929 depression, these sources of new credit dried up and Germany was no longer able to make the foreign payments expected of her.

The Repudiation of Debts.—This situation eventually resulted in Germany's refusal to make payments on account of principal and interest to creditors in other countries. The Germans did not view this action as repudiation, however, for German debtors were forced to continue to make payments on account of interest and principal in terms of marks. These payments were made to German financial institutions for the benefit of foreign creditors, but the funds could not be transferred to other countries. They might be used to pay traveling expenses in Germany, for new investments or reinvestment in Germany, and for meeting various kinds of obligations in Germany. They could not be sent abroad because Germany was unable to acquire necessary foreign exchange balances abroad from which payments could be made in foreign countries. There is little doubt about the genuineness of the German financial difficulties, for, in addition to making normal payments abroad for imports and on account of principal and interest, she would have been compelled to make large payments to foreign creditors who were desirous of recalling their investments in Germany through fear of the present régime. However, her action amounts to repudiation of her obligations, from the point of view of many foreign creditors.

Foreign Trade.—As a result of this situation, the German government has found it necessary to place Germany's foreign trade on a cash basis. The government has had to restrict imports to goods that were urgently needed, and for which payments could be made out of foreign funds acquired through German exports. That is, the general rule has been not to import unless and until it was definitely known where and when foreign sales could be made to pay for the imports. Germany has also attempted to establish arrangements through which imports and exports could go on without the necessity of making cash payments. For example, under carefully stipulated regulations, it is now possible, if no other means are available, to import raw materials under agreements that they shall be paid for in such foreign money as may be collected from the foreign sale of the commodities manufactured from these same raw materials. Clearly, then, Germany has found it very difficult to export her manufactured goods in recent

years, and to obtain adequate supplies of food and vital raw materials.

The results of the restrictive policies are shown in the statistics of German trade with other countries. Sales of German goods abroad in 1933 were less than in 1932, although 1933 was a better business year in most countries. Even in 1935, when international trade had revived considerably throughout the world, the total of German imports and exports together was less than in 1934. German exports were greater in 1937 than in 1936, to the extent of about 750 million Reichsmarks, but Germany still has far less than its former relative share of world trade.[11]

The Self-sufficiency Policy.—Under the conditions just described, it is not surprising that Germany has been taking every possible step to become self-sufficient with respect to food and raw materials. Under the Four-Year Plan, German agriculture was expected to increase the output of foods and raw materials already being produced in Germany but in insufficient quantities. It was hoped to double the number of wool-giving sheep, and to double also the quantity of land used for raising fibrous and oil-bearing plants. German industries were asked to continue the development of artificial raw materials. As in Italy, efforts have been and are being made in Germany to increase the supply of farming land by draining swamps and reclaiming meadowland. The government is also encouraging the movement of population back to the soil, where families can at least produce their own food.

Attempts have been made to substitute concrete for steel in building, and rubber and plastics for steel in manufacturing; and new enterprises using steel may not be set up without governmental permission. Aluminum is being substituted for tin, zinc for brass and bronze, and copper for lead. Textiles made from cellulose are largely substituted for wool and cotton materials. Fish skins are made into imitation leather, and potato peelings into linoleum and corks. Artificial rubber and gasoline are also being produced. Recently, a new government steel plant, the largest in the country, was reported under construction. It was located in an agricultural district, and was to use ores so low in iron content that the plant could never have competed successfully with private industry.[12]

[11] *The Nation,* April 16, 1938, pp. 437-440.
[12] *Ibid.,* pp. 437-440, and *Living Age,* April, 1938, pp 110-116.

Financial Consequences of Germany's Economic and Military Policies.—In addition to the self-sufficiency program, Germany has been rearming at a rapid rate in recent years, and the effect on the government's financial position has been alarming. Governmental expenditures increased from 9.7 billion Reichsmarks in 1933-34 to 25.0 billions in 1937-38. Taxation in the same period of time increased from 6.8 to 14.0 billion Reichsmarks per year, and governmental borrowing increased from 2.1 to 9.3 billion Reichsmarks per year. The national debt, which was wiped out during the post-war inflation, rose from 9.5 to 38 billion Reichsmarks in the years 1933 to 1937. We see, then, that public expenditures almost tripled, and taxation more than doubled, in a period during which the national income was increasing by about 50 per cent.[13]

Effects of the Above Policies on German Industry.—The effects of rearmament and the self-sufficiency program on German industry may be described as tragic. Dividends have been strictly limited, and most industrial profits have been appropriated by the government for use in building new plant and equipment under the Four-Year Plan. These new facilities cost approximately 3.5 billion Reichsmarks in 1937 alone. The consequence is that plant and equipment in regular German industries have been allowed to run down to a serious extent. In spite of all efforts to provide an adequate supply of raw materials, German industries have suffered from an acute shortage of these essentials, and the shortage has sometimes held up work for weeks or even months. It is reported, for example, that shipyards can obtain steel plates only after waiting some eight months from the date of order.

Economic activity in Germany is conducted under endless regulations and restrictions. One large commercial bank is said to employ five hundred officials for handling foreign exchange regulations alone. Manufacturers can secure limited quantities of needed raw materials only by application, supported by data on past consumption and present stocks, and accompanied by proof of orders in hand for the finished products. Countless obstacles are placed in the way of importation. In short, it has been said that almost all commercial, financial, and industrial activities are criminal offenses unless governmental permission has been obtained.[14]

[13] *Living Age,* April, 1938, pp. 110-116.

[14] *Ibid.,* and *New Republic,* February 9, 1938, pp. 14-16.

Employment and Standards of Living.—Increased economic activity under the rearmament and self-sufficiency programs has apparently eliminated unemployment, and even created a shortage of labor in Germany. The replacement of labor by machinery would undoubtedly be stimulated at present, except for the fact that many industries cannot get even enough new capital goods to replace machinery as it wears out. But the increase in production and employment has not been accompanied by an increase in consumers' goods, so that the standards of living for most of the people have been greatly reduced. Of course, persons who were formerly unemployed are better off now that they have jobs, but others have experienced a substantial decline in their standards of living. Goods produced with artificial raw materials and machinery that is largely worn out, tend to be either poor in quality or high in price, or both; and the shortage of many common articles of consumption makes it necessary to use more expensive commodities in their stead. Moreover, the manufacture of substitutes frequently uses up supplies of other materials which are themselves none too plentiful, and may thus increase, rather than diminish, Germany's dependence on other countries. Many consumers' goods, such as margarine, fat, and bacon, are rationed by a card system, as they were during the World War.

The Control of Industry.—Germany does not, like Italy, have syndicates of employers in various industries, but she does attempt to organize industrial enterprises into associations for the purpose of serving as instruments of national economic policy, and for increasing cooperation among the several branches of industry. While Italian industrial units are, generally speaking, small-scale, those in Germany are relatively large-scale, and were already organized into great trusts or cartels long before the advent of National Socialism. The Nazi industrial policy, in its first stage, brought about a provisional regrouping of industrial units, and subjected the provisional associations to political supervision. The second stage was occupied with founding the Estate of Industry and Trade, by means of which industry and trade were classified functionally into six national branches of business. At present, the industrial policy is in its third stage, which is one of simplification and strengthening. All features of the system which are not essential as instruments of leadership from above, or of cooperation from below, are to be eliminated or altered.

The Organization and Control of Labor.—While the German government does not undertake direct control over the distribution of the national income among enterprisers, landowners, capitalists, and workers, it does supervise very closely the organization of labor and the relations of workers and employers. In these respects, the German system is quite similar to that of Italy. When National Socialism came into power, the trade unions, in the ordinary sense of the term, were suppressed, and the German Labor Front was created. This organization was described as a totalitarian organization of all German citizens who take part in the country's industrial processes, and included ordinary workers, salaried employees, and employers. In this organization, however, all important functions were to be performed by official arbitrators appointed by the head of the government. These arbitrators settled wage disputes and other controversies, and decided when and under what conditions strikes should be permitted. The former trade union leaders were blacklisted and denied employment. Later, all strikes, stoppages, and lockouts were prohibited, and certain classes of workers were forbidden to demand wage increases.

Finally, in 1934, a new law for the regulation of labor was announced. This law dissolves all organizations of labor, and gives to the individual employer a large measure of control over the workers in his plant. According to the official German news bureau, "the basis of the new social system is the factory. The Leader is the employer. He decides for the Following (employees) in all questions concerning the management of the plant. . . . The Following shall render faithful service to the Leader in all things related to the conduct of the undertaking. . . . This law revokes all previous laws of basic significance relating to shop councils, wage agreements, arbitration, strikes and lockouts, and similar questions."

Since 1933, several thousand labor regulations have been set up in Germany. These are of two main types. In the first place, there are *establishment regulations*, or shop rules, covering such matters as daily working hours, time and conditions of wage payment, basis of wage calculation, fines, dismissals without notice, and disposition of forfeited wages. These regulations are made by the Leader (employer), and cover a single plant or establishment. Secondly, there are *labor regulations*, covering wages, hours, vacations, dismissals, and other labor conditions, which may apply

to a group of plants, a whole industry, or several industries in one district or several districts. These regulations are issued by the Labor Trustees. The country is divided into thirteen trade and industrial regions, each under the control of an appointed Labor Trustee. The Trustees are expected to maintain industrial peace, oversee the appointment of advisory shop councils of workers, approve or remove members of these councils, approve or disapprove the establishment of regulations and supervise their administration, set up minimum labor conditions, and issue labor regulations.[15]

The supporters of National Socialism contend that the employer's domination over labor is not so complete as might be supposed from the above description, for the law forbids the employer to misuse his powers to exploit his employees. The Labor Trustees (acting under their powers, as listed above) and the so-called Courts of Honor are authorized to bring offending employers to justice. If a worker feels that his employer has been mistreating him, he may appeal to the proper Trustee. If the latter agrees that the employer is at fault, he proposes proceedings before a Court of Honor. Such courts may punish employers severely for malicious exploitation of labor, for willful insults to social honor, and for non-compliance with written ordinances of the Trustee. Malicious exploitation of labor includes unlawful overtime work, paying wages below the prevailing wage scales, undue speeding up of labor, providing insanitary working conditions, and the denial of vacation rights. Insults to social honor include such matters as arbitrary dismissal and the use of insulting language. It is claimed that cases which come before the Courts of Honor are decided promptly and with justice to the workers.

On the other hand, opponents of the present régime charge that the Trustees and Courts of Honor are mere makeshifts designed to conceal the domination of workers by employers. They say that the Trustees really work hand in glove with the employers, and are disposed to protect the employers' interests at all costs. Each Court of Honor consists of a judge, an employer from the plant in question, and a third person selected by these two. Under this set-up, it might seem difficult to get decisions favorable to labor from these Courts. All in all, it does not appear that the Nazi system of labor control is one which is calculated

[15] *Monthly Labor Review,* January, 1938, pp 94-97.

to protect the workers' interests or enhance their welfare.[16] Moreover, there are reasons for suspecting that the new system is not altogether satisfactory even to the employers themselves, despite the great power they exercise. To be sure, labor is unorganized and has no legal right to strike, but unsanctioned strikes sometimes occur and there is considerable soldiering on the job in German industry. Because of their fear of a new undercover revolutionary movement among workers, employers are said to maintain factory police who are prepared at all times to handle workers' uprisings.[17] If the workers do not obey the employers, the police may be called in, but it is believed by some persons that many employers would prefer the old union organizations, with all their strikes, to the present situation.

The Attack on Unemployment.—The virtual disappearance of unemployment in Germany is not entirely attributable to the self-sufficiency and rearmament programs, although they provided an effective weapon in the attack on unemployment, which was very serious when the Nazi Party came into power. Other devices for reducing unemployment had been used earlier, and with apparently significant results. One phase of the problem had to do with shifting people to the farms, where there was a considerable shortage of labor. The lack of farm workers was attributed to the continued growth of intensive farming, and to the tendency of farm workers to leave the country and obtain more profitable work in the cities. It was also discovered that the age ratios in some industries were not in line with the political-social needs of the country. The revival of trade had contributed largely to the benefit of the younger rather than the older workers, and the government used its power to aid these older laborers. A plan was set up for transferring workers from one area to another. Employers were required to secure permits from the government when they wished to employ workers under 25 years of age, and a governmental bonus was granted to employers who hired additional workers of 40 years or over.

Governmental labor exchanges were set up to assist in securing reemployment for labor. It was intended that, through these exchanges, vacancies occurring in industry would be filled at once, without slowing down the rate of production of any enterprise.

[16] P. Van Paassen and J. W. Wise, editors, *Nazism—An Assault on Civilization*, New York, Random House, Inc., 1934, p. 113.

[17] *New Republic*, February 9, 1938, pp. 14-16.

Moreover, these exchanges were expected to fill vacancies with workers whose abilities and training suited them for the positions in question. To gain these ends, it was held that the placement of labor had to be strictly controlled by the government in the interest of the national welfare. It was said, also, that the restrictions placed upon the free choice of occupations by workers must be continued even after the immediate problem of unemployment was solved. In addition to its other labor policies, National Socialism has maintained the system of social insurance for German workers, which had been in force for many years. According to official figures, unemployment was reduced 61 per cent in the first two years under National Socialism,[18] and the self-sufficiency and rearmament policies have apparently completed the task.

The Population Policy.—Despite its attempt to bring about economic self-sufficiency for Germany, the difficulty of finding useful work for the present labor supply, the existing population pressure, and the need for colonies, National Socialism, like fascism in Italy, is following a policy of encouraging the growth of population. This policy must be interpreted, therefore, as one which is pursued for military purposes. Governmental loans have been granted to young married couples, the cost of education and other expenses of rearing children have been reduced, and the income tax laws have been amended in favor of taxpayers with large families. Single-payment bonuses have been offered to the parents of large families, and in July, 1936, it was announced that a supplementary bonus of 10 marks per month would be paid to parents for their fifth child, and yet another for every additional child after the fifth. In Germany, as in Italy, in spite of all forms of governmental encouragement, the birth rate shows little inclination to rise. The birth rate in 1935, while higher than that for 1933, was only 18.9 per thousand of population, as compared with 27.5 per thousand in 1913.[19]

The Military Policy.—In the face of loud public protestations as to the peace-loving character of National Socialism, it is clear that since this party came into power Germany has rearmed rapidly, at first secretly and later openly, in defiance of the Treaty of Versailles and other international agreements. The youth of the land is organized and given training which, even if not directly

[18] *News in Brief,* January, 1936, p. 9. (Published by the Deutscher Akademischer Austauschdienst)

[19] *The Berlin Weekly,* June 3, 1936, p. 5.

military in nature, lays the foundation for military training in later years. The army itself has been greatly enlarged under National Socialism. Being prepared for war, Germany has been able to absorb Austria completely and take over important sections of Czechoslovakia. It is also evident that Germany's program for expanding her territory, population, and resources is not to stop at this point. Thus far, Herr Hitler has been able to rattle his saber loudly enough to intimidate the other European powers, and has been permitted to grab adjacent territory without actual armed conflict. But the continuation of this program for a greater Germany is liable to result in a major war at almost any time. In any event, further success of the policy of expansion would be likely to give Germany the foodstuff, raw materials, and other resources which she now lacks, and would thus render the self-sufficiency program an almost complete waste.

The Results of National Socialism.—It is difficult at present to make a lasting evaluation of the accomplishments of National Socialism, for the party has been in power for only a relatively short time. Moreover, its economic policies have been in effect during a period of time in which economic recovery has been taking place all over the world. Again, since official statistics in Germany are controlled by the party, there is some question as to their reliability. The statistics given us are imposing, since they involve, from 1933 through 1937, the conquest of unemployment, with an increase in employment from 12,580,000 to 18,960,000; an increase in the gross value of production from 40 to 75 or 80 billion Reichsmarks; an increase in steel production from 5.5 to 20 million tons; an increase in the number of houses erected annually from 131,000 to 300,000; and an increase in the national income from 45 to 88.5 billion Reichsmarks.[20]

However, as we noted previously, the gains in employment, production, and national income took place without a corresponding increase in goods available for consumption, and, indeed, with an actual decline in standards of living. It follows that these statistics can be interpreted fairly only in the light of the nature and content of the Nazi policies. It is necessary to recognize that in Germany, as in Italy, the interests of individuals are regarded as unimportant as compared with those of the nation or race. The policies of National Socialism seem to be directed definitely toward enhancing the power and prestige of the nation or race, rather

[20] *The Nation,* April 16, 1938, pp. 437-440.

than toward producing a more abundant economic life for the citizens of Germany. National Socialism does not appear to be a system under which the individual may hope to achieve a high measure of economic welfare. His income in the form of commodities and services is likely to be small, but he may derive considerable psychic income from the glory of being a German citizen, if the Nazi policies enable Germany to regain and hold her former position as a leading world power.

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1. Why is fascism often confused with socialism and communism? Explain.
2. In what way has the organization of the Italian government been changed under fascism?
3. "Italy, under fascism, has a one-party system of government." What is meant by this statement?
4. What is the status of individual rights and liberties under Italian fascism? Explain.
5. Explain the fascist theory of the state.
6. Does Italy operate under a system of national economic planning at present? Explain.
7. What differences have there been, as between Italy and Russia, in the original sources of support for the party now dominant, and the reasons for subordinating the interests of individuals to those of the state?
8. Is Italy, like Russia, apparently immune to business depressions and unemployment? Explain.
9. What is meant by saying that Italian fascism is a form of "state capitalism"?
10. How are workers and employers organized for dealing with each other in Italy? Explain.
11. How are labor questions settled under the fascist system? Explain.
12. How would you evaluate the results of the fascist labor policies?
13. What have been the nature and results of the fascist financial policies? Explain.
14. Why has Italy adopted a policy of trying to achieve economic self-sufficiency?
15. Can such a policy be successfully carried out in Italy? Why or why not?
16. How does this policy tend to affect the economic welfare of individual citizens? Explain.
17. Discuss the fascist population and military policies.
18. How does the governmental organization in Germany under National Socialism compare with that of Italy under fascism? Explain.

19. Are individual rights and liberties well protected in Germany at the present time? Explain.
20. What differences may be noted between Italy and Germany, in the suppression of opposition to the Fascist and National Socialist Parties? Explain.
21. How do Germany and Italy compare in the matter of economic planning?
22. Explain the nature of and reasons for Germany's policies, under National Socialism, with respect to investments in Germany by foreigners and with respect to foreign trade.
23. Is the German self-sufficiency policy identical with that of Italy? Explain.
24. What have been the effects of Germany's policies of self-sufficiency and rearmament on (a) government finances, (b) industry, and (c) employment and standards of living?
25. How is industry controlled in Germany?
26. Describe the present German policies relating to labor organization and the control of labor relations, and compare these policies with those in operation in Italy.
27. How did National Socialism, in its early years, attack the problem of unemployment, and with what results?
28. In what respects are the National Socialist policies relating to population and militarism, similar to those of Italy under fascism?
29. Is German National Socialism a system under which individual citizens may expect to enjoy a high degree of economic welfare? Why, or why not?

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